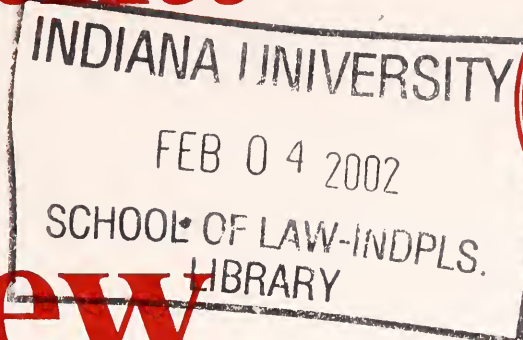


# Indiana Law Review



Volume 35 No. 1 2001

## TRIBUTE

Professor Clyde H. Crockett: A Personal Recollection and Tribute  
*William F. Harvey*

## ARTICLES

The 2001 Federal Economic Crime Sentencing Reforms: An Analysis and  
Legislative History  
*Frank O. Bowman, III*

Subsidiarity as a Principle of Governance: Beyond Devolution  
*Robert K. Vischer*

Are There Procedural Deficiencies in Tax Fraud Cases?:  
A Reply to Professor Schoenfeld  
*Leandra Lederman*

Credit Crisis to Education Emergency: The Constitutionality of Model Student  
Voucher Programs Under the Indiana Constitution  
*Barclay Thomas Johnson*

## NOTES

Artificial Insemination: Right of Privacy and the  
Difficulty in Maintaining Donor Anonymity  
*Lucy R. Dollens*

Nonphysical Personal Injury Settlements and Judgments: Amending the Internal  
Revenue Code to Exclude Attorney Fees  
*Paul M. Jones, Jr.*

The H-2A Program: How the Weight of Agricultural Employer Subsidies Is  
Breaking the Backs of Domestic Migrant Farm Workers  
*Andrew Scott Kosegi*

The Case Against Carnivore: Preventing Law Enforcement  
from Devouring Privacy  
*Peter J. Young*

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## TABLE OF CONTENTS

### TRIBUTE

- Professor Clyde H. Crockett: A Personal Recollection  
and Tribute ..... *William F. Harvey* 1

### ARTICLES

- The 2001 Federal Economic Crime Sentencing  
Reforms: An Analysis and  
Legislative History ..... *Frank O. Bowman, III* 5
- Subsidiarity as a Principle of Governance:  
Beyond Devolution ..... *Robert K. Vischer* 103
- Are There Procedural Deficiencies in Tax Fraud Cases?:  
A Reply to Professor Schoenfeld ..... *Leandra Lederman* 143
- Credit Crisis to Education Emergency: The Constitutionality  
of Model Student Voucher Programs Under  
the Indiana Constitution ..... *Barclay Thomas Johnson* 173

### NOTES

- Artificial Insemination: Right of Privacy and the Difficulty  
in Maintaining Donor Anonymity ..... *Lucy R. Dollens* 213
- Nonphysical Personal Injury Settlements and Judgments:  
Amending the Internal Revenue Code  
to Exclude Attorney Fees ..... *Paul M. Jones, Jr.* 245
- The H-2A Program: How the Weight of Agricultural  
Employer Subsidies Is Breaking the Backs  
of Domestic Migrant Farm Workers ..... *Andrew Scott Kosegi* 269
- The Case Against Carnivore: Preventing Law Enforcement  
from Devouring Privacy ..... *Peter J. Young* 303





# **PROFESSOR CLYDE H. CROCKETT**

## **A PERSONAL RECOLLECTION AND TRIBUTE**

**WILLIAM F. HARVEY\***

Professor Clyde H. Crockett retired from the law school's faculty in 2001. He joined the faculty in 1973. He was an able teacher who respected students. He was a splendid faculty member because he understood the standards and criteria that establish the purpose and function of a law school as an academic institution in a community of schools and colleges called a university.

His J.D. was taken at the University of Texas School of Law. He received an LL.M. from the same institution. He attended the London School of Economics. He was a Judge Advocate in the United States Air Force, and a General Attorney in the United States Maritime Commission. He was the Director of the International Trade Law Program in the Law School. He taught courses in Admiralty, Civil Procedure, Conflict of Laws, Federal Jurisdiction, International Civil Litigation, and International Law.

We first met in the summer of 1973. He entered my office to introduce himself. He was as new to legal education as I was to the law school's deanship that commenced only a few days earlier in that summer.

Initial impressions are said to be the strongest. My initial impression of Clyde Crockett was strong and it did not change during the next twenty-five years. His constant personality was a delightful mixture of cheer with discipline, a gentle impishness blended with profound respect, and wisdom undiluted by the trivia that daily pervades schools of higher education and law schools in particular. He displayed politeness, manners, and goodwill toward others who never understood those norms or delighted in repudiating them with boisterous contempt. Always, he showed kindness and compassion from the core of his being. This showing was not limited to special friends, or selected students, or to a dean who could affect his life and career. It was and is the man himself. In few words, he was genuine. He had the "right stuff."

Almost fifty years ago, Justice Felix Frankfurter returned to the Harvard Law School and spoke to a graduating class. In his comments, the Justice said that the law, more than any other profession, discipline, or calling, has been concerned with those standards, those criteria, those appeals to right and reason, that have had a dominant share in begetting a civilized society. Professor Crockett was educated in these ideals and ideas. He brought them to his classroom and to the law school. He understood magnificent principles, standards, criteria, and their history.

He brought them to an American legal educational community that had begun its disintegration into sophistic babble. Let us listen to Professor Crockett's opponents, and understand their views.

Discipline? Standards? Criteria? Judgment? What are these? To today's type of realist, a postmodernist Derrida-dandy, appeals to right and reason, and a dominant share in begetting a civilized society are disgusting triumphalism!

---

\* Dean Emeritus and Carl M. Gray Emeritus Professor of Law, Indiana University School of Law—Indianapolis.

What is a civilized society? No one can say because there are no standards for such a concept. If you offer a judgment then you are merely judgmental and probably infected by DWEMs (dead white European males). If you express an opinion it cannot be superior to other opinions because there are no standards. (Well, other than this one, but do not talk about this one either). As for Felix Frankfurter—"who is he?"

Constitutional Law. This subject, they announce, is the greatest ruse in a law school's curriculum. It is a course with a large, heavy, expensive book filled with cases that are valid only because the Justice or judge who wrote the opinion received five votes, or some other form of numerical agreement.

You doubt what we say? Well, then, ask one of our own: Justice William J. Brennan. He would tell you, as he told his law clerks: the only thing that matters in this Court is the most important word in Constitutional Law. That word is "five." "Look, law clerk," Brennan might say, "get me five votes, and we have the law." What a guy! What a sense of history! Such institutional integrity!

Look at Criminal Law say the contemporary realists. When Professor Crockett attended law school or when he commenced teaching, the allegations state, Criminal Law was addressed in an archaic manner. People really thought in terms of crime and the moral standards that, ultimately, defined crime. That was an ancient regime. Today's law school rulers allege that crime is nothing more than the way that persons are perceived by the police, and then arrested and accused. One cannot say that an act is "criminal." If an act destroys property so be it because private property is theft anyway. If an act harms another person, then seek "the cause" that can be understood only in terms of poverty, dispossession, or an unequal distribution of goods. If children are involved, then if it is necessary to save them you may kill them. This is, was it not, the teaching of Attorney General Reno?

In rebuttal, Professor Crockett might have quoted from Leroy S. Rouner who wrote that the best thing ever written on the philosophy of education is Plato's *Protagoras*. (Leroy S. Rouner, *Resolved: That Phi Beta Kappa is Gloriously Useless*, 66 THE KEY REPORTERS 1, 4-6 (2000)). Protagoras was a sophist, an ethical relativist who would teach a student how to make a speech without knowing what justice or the content of the speech really means. When a young man asks Socrates to make arrangements for this instruction, Socrates asks the crucial question: "If you study with this fellow, what will he make of you?"

Rouner continues saying that this is not a question that a college dean's office will address today. In legal education, the condition is much worse than Rouner's college dean.

Professor Stephen B. Presser, Raoul Berger Professor of Legal History at Northwestern University says that something has gone radically awry with legal education. (Stephen B. Presser, *Can America's Legal Education Be Fixed?*, CHRONICLES 50-53 (Jan. 2001)). Today's lawyers commonly regard the law as an infinitely malleable set of theories and doctrines that can be manipulated by judges at the prompting of clever advocates. With the triumph of legal realism at Yale and Columbia in the 1930s and 1940s, law professors (in those schools, but clearly not everywhere at that time) believed that there are no overarching



ethical—or other—principles in the law. Thus, a wholesale attack on the doctrines of constitutional law occurred. By the late Twentieth Century, prominent professors at Yale, with straight faces, could say that there was no need to amend the Constitution. A “living Constitution” can be altered simply by judges acknowledging the articulated desires of the people. Of course, Professor Presser states, “the people” are Yale law school professors.

No doubt the Yale crowd had a moment of great pride when their most distinguished graduate defined reality by insisting that it depends on what the meaning of “is” is. Perhaps their greatest moment arrived when this same graduate had to plea bargain his exit from the White House in order to end his term in office without indictment.

Professor Presser’s solution for reforming legal education “is to return to a required curriculum with a heavy dose of the history of American law.” He says, “As the rule of law has eroded in recent years and the Constitution has been pummeled, it is no wonder that we have trembled on the edge of urban unrest, plunged into the crass excesses of materialism, and completely lost our moral bearings.” He refers to Chief Judge Harry Edwards of the United States Court of Appeals for the District of Columbia Circuit. Professor Presser states that Judge Edwards’ article in the *Michigan Law Review* in 1992, in which he said that law schools are obsessed with impractical theories and law firms maximizing revenues, means that both law schools and law firms have disregarded the ethical practice of law.

There is much more that Professor Presser might have observed. The reaction to the criticism by Judge Edwards was entirely predictable and entirely beside the point. The reaction was (a) require more hours in legal ethics courses taught in law schools, and (b) demand that all members of the state’s bar attend continuing legal educational classes in ethics during a calendar year. This resulted in little more than adding substantial cost burdens to the law student, whose law schools costs and incurred debt are appallingly excessive already, or the attorney, who can not afford either the time or the money. All of this occurs because of nothing more than an assumed benefit. It is that the law student or the attorney will be an ethical person. The spirit of the thing seems to be, “take these courses or continuing legal educational courses, and then you will be ethical. Damn it!”

This assumed benefit can be postulated only by disregarding the wholesale abolition of ethical standards, the dismissal of a moral order, the repudiation of ultimate social criteria, the abolition of American and British legal history, the corrosive rejection of the laws and history of organized religion(s) in a law school curriculum, and the denial of classical educational criteria that occur throughout the courses in today’s law school curriculum.

What a philosophy! What a basis for law! But this was not Professor Crockett’s doing. These are not the principles (should one say, “non-principles”) that he understood and defended in his fine career. Professor Crockett did side with Frankfurter. In his own way, he, too, maintained that law has standards and that the law, more than any other profession, discipline, or calling, has been concerned with those standards, those criteria, those appeals to right and reason, that have had a dominant share in begetting a civilized society.



Perhaps Professor Crockett already sensed Professor Presser's prediction: if the American law school does not change and draw upon the classical moral and religious traditions of the Eighteenth and Nineteenth Centuries, and recapture the benefits of professional apprenticeship as a means of legal education, it may not last throughout this century. Or perhaps Professor Crockett fought the good fight and stayed the course because of the principles themselves. In my observations of him, he clearly understood what was at issue. He understood the principles and the impact that their destruction has inflicted upon the American social order. He was a splendid faculty member and I was honored to be his colleague for over twenty-five years.

## ARTICLES

### **THE 2001 FEDERAL ECONOMIC CRIME SENTENCING REFORMS: AN ANALYSIS AND LEGISLATIVE HISTORY**

FRANK O. BOWMAN, III\*

#### TABLE OF CONTENTS

Introduction .....	7
I. The General Structure of the Guidelines and Their Original Approach to Sentencing Economic Crimes .....	9
A. <i>The Structure of the Federal Sentencing Guidelines</i> .....	9
B. <i>The Federal Sentencing Guidelines for the Economic Offender</i> ...	12
1. Sentencing the Economic Criminal: Some History .....	12
2. The Original Guidelines' Approach to Economic Crimes .....	20
II. The Case for Reform .....	24
A. <i>Consolidation of the Former Theft and Fraud Guidelines</i> .....	24
B. <i>The "Loss" Conundrum</i> .....	25
C. <i>Sentencing Severity in Economic Offenses</i> .....	29
D. <i>Money Laundering</i> .....	31
III. A Procedural History of the 2001 Economic Crime Package: The Amendments to the Former Theft and Fraud Guidelines .....	32

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IV. An Analysis and Critique of the Most Important Provisions of the 2001 Economic Crime Package .....	38
A. <i>The Fundamental Choices</i> .....	38
1. The Retention of "Loss" as the Core Measurement of Offense Severity .....	38
2. The Decision to Define "Loss" in Terms of Causation .....	41
a. Leaving causation undefined was not a viable option .....	43
b. Reasonable foreseeability is the best available causation standard .....	43
c. The criminal law traditionally imposes punishments for reasonably foreseeable harms caused by a defendant's criminal conduct .....	45
d. A reasonable foreseeability standard requires an assessment of the defendant's blameworthiness by requiring a nexus between the defendant's state of mind and harms counted as loss .....	47
B. <i>The Details of the New Definition of Actual Loss</i> .....	47
1. The Limitation to Harm That "Resulted from" the Offense ...	48
a. "But for" causation .....	48
b. Temporal limitations on includable losses .....	48
2. The Meaning of "the Offense" .....	48
3. The Limitation to Pecuniary Harm .....	49
4. Product Substitution, Procurement Fraud, and Protected Computer Cases—Specific Examples of Reasonably Foreseeable Pecuniary Harms or Special Cases? .....	50
C. <i>Pecuniary Harms Excluded from Actual Loss</i> .....	52
1. The Exclusion from Loss of Foreseeable Investigative Costs of the Government, and Costs Incurred by Victims in Aiding the Government .....	52
2. The Exclusion from Loss of Interest .....	53
a. An analysis of the arguments for inclusion of interest ....	54
b. "Bargained-for" interest .....	54
c. Additional arguments for total exclusion of interest .....	56
d. The Commission's decision to exclude interest .....	56
e. The upward departure for interest .....	56
D. "Net" vs. "Gross" Loss: <i>The Problem of Accounting for Things of Value Transferred to the Victim by the Defendant</i> .....	57
1. The Law Under the Former Theft and Fraud Guidelines .....	57
2. The New Economic Crime Guide Guidelines Adopt a Net Approach to Loss .....	61
3. The Language of the New Crediting Rule .....	62
4. Investment Fraud Cases .....	63
5. Regulatory Offenses and Unlicensed Professionals .....	65
6. Items of de minimis Value .....	67
E. <i>Time-of-Measurement</i> .....	68
1. The New Time-of-Measurement Rules for Crediting .....	68
a. Precious metals/rare coins boiler room .....	69



b. Stock fraud ..... 69

    2. Timing Issues Left to the Courts ..... 70

F. *Gain* ..... 72

    1. The New Economic Crime Guideline Retains “Gain” as a  
        Method of Estimating Loss ..... 73

    2. Gain and Regulatory Fraud ..... 74

    3. The Rejected Downward Departure for “Gain” ..... 74

G. *Intended Loss* ..... 75

    1. The Theory of Including Intended Loss in Economic Crime  
        Sentencing ..... 75

    2. The Language of the New Intended Loss Rule ..... 77

    3. Impossibility and “Economic Reality” ..... 78

        a. “Sting” operations ..... 78

        b. General impossibility or improbability ..... 80

H. *Enhancements* ..... 81

I. *Departures* ..... 83

    1. Upward Departures ..... 83

    2. Downward Departures ..... 84

J. *Ex Post Facto Considerations* ..... 84

K. *Changes in Money Laundering Guidelines* ..... 84

Conclusion ..... 85

Appendix A ..... 86

Appendix B ..... 96

INTRODUCTION

On April 6, 2001, the United States Sentencing Commission approved a group of amendments to guidelines governing the sentencing of economic crimes. These measures, known collectively as the “economic crime package,” were the culmination of some six years of consultation and debate by the Sentencing Commission, the defense bar, the Justice Department, probation officers, the Criminal Law Committee of the U.S. Judicial Conference (CLC), and the occasional academic commentator. The package contains four basic components. First, the formerly separate theft and fraud guidelines have been consolidated into a single guideline.<sup>1</sup> Second, the “loss table” in the consolidated guideline has been simplified and also substantively modified to reduce the sentences of some low-loss offenders while increasing the sentences of some high-loss offenders.<sup>2</sup> Third, the troublesome term “loss” has, at long last, been redefined.<sup>3</sup>

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1. Compare U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 and § 2F1.1 (2000) (former theft and fraud guidelines) [hereinafter U.S.S.G.], with U.S.S.G. § 2B1.1 (2001) (new consolidated economic crime guideline).

2. Compare U.S.S.G. § 2B1.1(b)(1) and § 2F1.1(b)(1) (2000) (former theft and fraud guidelines loss tables), with U.S.S.G. § 2B1.1(b)(1) (2001) (new consolidated economic crime guideline loss table).

3. See U.S.S.G. § 2B1.1, app. n.2 (2001) (defining “loss” in new consolidated economic

Fourth, the Commission approved changes to the money laundering guidelines that tied offense levels for money laundering more closely to the offense levels of the underlying crime from which the illegal funds were derived.<sup>4</sup>

The economic crime package is a milestone in the history of the Federal Sentencing Guidelines. Its provisions are substantively important because economic crimes comprise between one-fifth and one-quarter of all federal sentencings.<sup>5</sup> The economic crime package represents the first occasion in the nearly fifteen-year history of the Guidelines that the Sentencing Commission has thoroughly rewritten the guidelines governing a major crime category. Of perhaps even greater long-term significance than the substance of the 2001 economic crime amendments is the process that produced them. One of the most persistent criticisms of the Sentencing Commission has been that, to those in the legal community, guidelines' amendments have often seemed to appear out of nowhere, generated with little or no prior public debate and accompanied by no meaningful explanation. Historically, the Commission has used its anomalous status as a quasi-judicial body exempt from the Administrative Procedures Act to conduct much of its work out of the public eye. However, beginning with the term of Chairman Richard Conaboy and continuing under the leadership of the current chair, Judge Diana E. Murphy, the Commission has moved towards a more open and inclusive deliberative process. The economic crime package is the first federal sentencing reform initiative in the guidelines era to have been conducted in the public eye from its inception.

As a participant throughout the long gestation of the economic crime package,<sup>6</sup> I hope that the judges and lawyers who use the new economic crime

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crime guideline).

4. See *id.* § 2S1.1. Although the money laundering amendments were not originally conceived as part of the economic crime package, they are important not only in themselves but also insofar as they reduce the incentive of prosecutors to trump the otherwise applicable fraud guideline by adding a money laundering charge. See *infra* notes 146-51 and accompanying text.

5. In 1999, 22.6% of federal criminal defendants were sentenced for fraud, larceny, embezzlement, auto theft, robbery, burglary, forgery, or counterfeiting. U.S. SENTENCING COMM'N, 1999 SOURCEBOOK OF FEDERAL SENTENCING STATISTICS 12, tbl. 3 (1999) [hereinafter 1999 SOURCEBOOK]. The percentage of economic crimes as a proportion of all federal offenses has declined slightly in the last few years, although the absolute number of such offenses has increased. For example, in fiscal year 1995, 26.5% of the federal sentences imposed were for auto theft, larceny, fraud, embezzlement, forgery, or counterfeiting. U.S. SENTENCING COMM'N, ANNUAL REPORT 1995 43, tbl. 10 (1995) [hereinafter 1995 ANNUAL REPORT].

6. From 1995 to 1996, when work on the economic crime package began, I was Special Counsel to the U.S. Sentencing Commission, on detail from the Justice Department, and served as a member of the Sentencing Commission staff working group on economic crime. During that same period, I participated in the work of the Sentencing Subcommittee of the Attorney General's Advisory Committee (a group of U.S. Attorneys who, as the name implies, advise the Attorney General on matters of policy). After I left the Commission and the Justice Department to teach law in 1996, I began writing about economic crime sentencing reform and became a member of Sentencing Commission's Practitioner's Advisory Group. Beginning in 1998, I was privileged to



guidelines will conclude that the more open and participatory process generated high quality sentencing rules. At any event, the process generated a rich and unprecedented “legislative history” that should be of great interpretive value to the bench and bar, particularly when addressing the nuances of the revised definition of “loss.” The purpose of this Article is simple—to assist lawyers and judges in understanding and applying the new consolidated economic crime guideline, set out in Section 2B1.1. It will also comment briefly on the revisions to the money laundering guidelines, insofar as those revisions impact economic crime sentencing.

This Article has four parts. First, it describes the general structure of the Federal Sentencing Guidelines and the approach to sentencing economic crimes in effect between 1987 and 2001. Second, it outlines the defects in the former economic crime guidelines that led to the call for reform. Third, it describes the process undertaken by the Sentencing Commission that led to the passage of the 2001 economic crime amendments and, in so doing, provides a roadmap to sources of legislative history. Fourth, it explains and analyzes the new guidelines in light of their legislative history, with primary emphasis on the consolidated economic crime guideline and its redefinition of “loss.” This fourth section highlights issues that remain unaddressed by the new guidelines and discusses provisions that may be particularly productive of future litigation.

For purposes of comparison and ease of reference, the text of the new economic crime guideline, Section 2B1.1 of the 2001 Federal Sentencing Guidelines, is set out in Appendix A, and the provisions of the former theft and fraud guidelines relating to loss are gathered in Appendix B.

## I. THE GENERAL STRUCTURE OF THE GUIDELINES AND THEIR ORIGINAL APPROACH TO SENTENCING ECONOMIC CRIMES

### A. *The Structure of the Federal Sentencing Guidelines*

The Federal Sentencing Guidelines adopted in 1987<sup>7</sup> are, in a sense, nothing more than a set of instructions for one chart—the Sentencing Table.<sup>8</sup> The goal of guidelines calculations is to arrive at numbers for the vertical (offense level) and horizontal (criminal history category) axes on the Sentencing Table grid, which in turn generate an intersection in the body of the grid. Each such

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serve as an academic advisor to the Criminal Law Committee of the U.S. Judicial Conference (CLC).

7. For a discussion of the federal sentence reform movement that, in general, rejected the rehabilitative model of sentencing and produced the Federal Sentencing Guidelines, see Frank O. Bowman, III, *The Quality of Mercy Must Be Restrained, and Other Lessons in Learning to Love the Federal Sentencing Guidelines*, 1996 WISC. L.R. 679, 680-92; Stephen Breyer, *The Federal Sentencing Guidelines and the Key Compromises Upon Which They Rest*, 17 HOFSTRA L. REV. 1 (1988); and Kate Stith & Steve Y. Koh, *The Politics of Sentencing Reform: The Legislative History of the Federal Sentencing Guidelines*, 28 WAKE FOREST L. REV. 223 (1993).

8. U.S.S.G., ch. 5, pt. A (2000).



intersection designates a sentencing range expressed in months. For example, a defendant whose offense level is 26, and whose criminal history category is I, is subject to a sentencing range of sixty-three to seventy-eight months.<sup>9</sup>

The criminal history calculation reflected on the horizontal axis of the Sentencing Table is a rough effort to determine the defendant's disposition to criminality, as reflected in the number and nature of his prior contacts with the criminal law. The basic unit of measurement in this calculation is prior sentences imposed for misdemeanors and felonies.<sup>10</sup>

The offense level reflected on the vertical axis of the Sentencing Table is a measurement of the seriousness of the present crime. The offense level calculation begins with the crime of which the defendant was actually convicted. The court must determine, primarily by reference to the "Statutory Index,"<sup>11</sup> which guideline in Chapter Two ("Offense Conduct") applies to that crime. Most Chapter Two offense conduct guidelines contain two basic components: a "base offense level"—a seriousness ranking based purely on the fact of conviction of a particular statutory violation—and a set of "specific offense characteristics." The "specific offense characteristics" are an effort to categorize and account for commonly occurring factors that cause us to think of one crime as worse than another. They "customize" the crime. For example, the guidelines differentiate between a theft of \$1000 and a theft of \$1 million,<sup>12</sup> or between a bank robbery where the robber hands the teller a note, and a robbery where the robber pistol whips the teller and shoots the bank guard.<sup>13</sup>

Once the court determines an offense level by applying the offense conduct rules from Chapter Two, it considers a series of other possible adjustments contained in Chapter Three. Increases in the offense level may be based on factors such as the defendant's role in the offense,<sup>14</sup> whether the defendant engaged in obstruction of justice,<sup>15</sup> whether the defendant committed an offense

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9. *Id.* By statute, the top end of the range can be no more than twenty-five percent higher than the bottom end. 28 U.S.C. § 994(b)(2) (1994); U.S.S.G. ch. 1, pt. A. For discussion of the "twenty-five percent rule," see Bowman, *supra* note 7, at 691 n.49.

10. For the rules regarding calculation of criminal history category, see U.S.S.G. ch. 4 (2000).

11. *Id.* app. A.

12. This was true under the former separate guidelines for theft and fraud. See, e.g., *id.* § 2B1.1(b)(1) (reflecting an increase in offense level of two for a theft of \$1000 and increase of thirteen for a theft of \$1 million). It remains the case under the recently adopted consolidated economic crime guideline. *Id.* (reflecting no increase in offense level for a theft or fraud loss of \$1000 and an increase of sixteen offense levels for a loss of \$1 million).

13. *Id.* § 2B3.1(b) (reflecting possible increases of up to eleven offense levels for the use of a weapon and causing injuries in the course of a robbery).

14. *Id.* § 3B1.1. The defendant's offense level can be enhanced by either two, three, or four levels depending on the degree of control he exercised over the criminal enterprise and on the size of that enterprise.

15. *Id.* § 3C1.1. Obstruction of justice includes conduct such as threatening witnesses, suborning perjury, producing false exculpatory documents, destroying evidence, and failing to

against a government official<sup>16</sup> or particularly vulnerable victim,<sup>17</sup> whether the offense was a hate crime,<sup>18</sup> and the existence of multiple counts of conviction.<sup>19</sup> The court may also reduce the offense level based on a defendant's "mitigating role" in the offense<sup>20</sup> or on his so-called "acceptance of responsibility."<sup>21</sup>

Once the court has determined the offense level on the vertical axis and the criminal history category on the horizontal axis, it can determine the sentencing range. The judge retains largely unfettered discretion to sentence *within that range*.<sup>22</sup> However, in order to "depart" from the range, that is, go above or below it, the judge must explain the reason for the departure, and the explanation must be couched in terms of factors for which the guidelines do not adequately account already.<sup>23</sup> Moreover, except in unusual circumstances, the guidelines specifically *exclude* from consideration for purposes of departing outside the guideline range most factors, such as age, employment record, or family ties, which judges formerly used to individualize sentences.<sup>24</sup>

Finally, the Sentencing Commission created "relevant conduct."<sup>25</sup> A

appear as ordered for trial. *Id.* § 3C1.1, app. 4.

16. *Id.* § 3A1.2.

17. *Id.* § 3A1.1(b)(1) (creating an enhancement where a victim was selected based on "race, color, religion, national origin, ethnicity, gender, disability, or sexual orientation" and in the case of a victim "unusually vulnerable due to age, physical or mental condition").

18. *Id.* § 3A1.1(a).

19. *Id.* ch.3, pt. D.

20. *Id.* § 3B1.2 (allowing decreases in offense level of two or four levels if defendant is found to be a "minor participant" or "minimal participant" in the criminal activity).

21. *Id.* § 3E1.1 (allowing reduction of two offense levels where defendant "clearly demonstrates acceptance of responsibility," and three offense levels if otherwise applicable offense level is at least 16 and defendant has "assisted authorities in the investigation or prosecution of his own misconduct" by taking certain steps). Despite the euphemism "acceptance of responsibility," Section 3E1.1 is nothing more nor less than an institutionalized incentive for guilty pleas.

22. *Id.* § 5C1.1(a) ("A sentence conforms with the guidelines for imprisonment if it is within the minimum and maximum terms of the applicable guideline range.").

23. 18 U.S.C. § 3553(c) (1994); U.S.S.G. § 5K2.0 (2000).

24. Chapter 5, Part H of the Guidelines lists factors that the Commission determined to be "not ordinarily relevant in determining whether a sentence should be outside the applicable guideline range." These include age, *id.* § 5H1.1; educational and vocational skills, *id.* § 5H1.2; mental and emotional conditions, *id.* § 5H1.3; physical condition, *id.* § 5H1.4; history of substance abuse, *id.* § 5H1.4; employment record, *id.* § 5H1.5; family or community ties, *id.* § 5H1.6; socio-economic status, *id.* § 5H1.10; military record, *id.* § 5H1.11; history of charitable good works, *id.* § 5H1.11; and "lack of guidance as a youth," *id.* § 5H1.12. In theory, most of these factors nonetheless can justify a departure, but such a departure is permissible only where the excluded factor is present to a degree so unusual that the Commission would not have anticipated its impact and thus did not "adequately [take it] into consideration," when formulating the guidelines. 18 U.S.C. § 3553(b) (1994).

25. The term "relevant conduct" and its applications to guideline calculations are enumerated in U.S.S.G. § 1B1.3 (2001). For a general discussion of relevant conduct and its function in the



thorough discussion of “relevant conduct” is beyond the scope of this article, but the essence of the concept is that the court can, indeed must, sentence each defendant based on *what he really did* as part of the same transaction or series of related transactions that resulted in the count of conviction, regardless of the specific offense of which a defendant is convicted after trial or as a result of a plea.

The inclusion in the guidelines of the “relevant conduct” concept, the customization of sentences through “specific offense characteristics” not included in the elements of the offense of conviction, and the rules governing sentences for multiple counts of conviction, taken together, transformed what would otherwise have been a predominantly “charge of conviction” system into a “modified real offense” system.<sup>26</sup> The “modified real offense” character of the system is of considerable importance in understanding the Guidelines’ approach to sentencing economic crimes.

In general, therefore, the Federal Sentencing Guidelines focus pervasively on offense seriousness. The explicit numerical yardstick of offense seriousness, the vertical “Offense Level” axis of the sentencing grid, has forty-three levels, while the horizontal “Criminal History” axis has only six. Because the sentencing range increases by equal increments along either axis, offense level customarily has a far greater effect on sentence than does criminal history.

### *B. The Federal Sentencing Guidelines for the Economic Offender*

1. *Sentencing the Economic Criminal: Some History.*—Creating a sentencing scheme for economic criminals prosecuted in federal courts presents greater difficulties than assigning sentences to those who commit crimes against persons. The first of these difficulties might be termed “historical.” The common law, and more particularly the body of Anglo-American statutory law that evolved from it, created a plethora of legal categories for crimes against persons that assigned offense seriousness rankings based primarily on only two ranking factors—the culpable mental state of the defendant and the degree of harm caused to the victim. For example, if Mr. A strikes Mr. B, the statutory law of most states stands ready to receive Mr. A into one of nine or more pre-defined categories ranging from capital murder to misdemeanor assault. If Mr. B dies from the blow, there are as many as six kinds of homicide, distinguished from

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guidelines system, see William W. Wilkins, Jr. & John R. Steer, *Relevant Conduct: The Cornerstone of the Federal Sentencing Guidelines*, 41 S.C.L. REV. 495 (1990). See also Bowman, *supra* note 7, at 702-04.

26. See, e.g., Daniel J. Sears, *Defense Practice Under the Bail Reform Acts and the Sentencing Guidelines—A Shifting Focus*, FED. PROBATION, Sept. 1991, at 38, 40 (categorizing the sentencing process under the guidelines as one based on “‘real offense’ behavior rather than the offense of conviction”). But see Jeffrey Standen, *Plea Bargaining in the Shadow of the Guidelines*, 81 CAL. L. REV. 1471, 1505-12 (1993) (asserting that the guidelines are actually a charged offense system).



each other primarily by different culpable mental states.<sup>27</sup> If Mr. B lives, there will generally be at least three types of assault charges available, usually differentiated by the degree of physical harm caused (or sometimes merely risked) to the victim and by the type of weapon employed.<sup>28</sup>

By contrast, in early law there were several different crimes of dishonest acquisition, but little or no difference in *degree* between them. It is generally believed that at earliest common law, all larcenies (the only property crime recognized for many years in England) were felony and punishable by death.<sup>29</sup>

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27. First degree murder generally involves both an intentional killing and some form of premeditation. *See, e.g.*, COLO. REV. STAT. ANN. § 18-3-102(1)(a) (West Supp. 2000). Second degree murder, where it exists, is usually either a “knowing” killing, *see, e.g.*, COLO. REV. STAT. ANN. § 18-3-103(1) (West 1999), or one carried out purposefully, but without premeditation, *see, e.g.*, WASH. REV. CODE ANN. § 9A.32.050(1)(a) (West 2000). Manslaughter is usually of two types, voluntary, which usually denotes some form of “heat of passion,” *see, e.g.*, VA. CODE ANN. § 18.2-35 (Mitchie 1996); MODEL PENAL CODE § 210.3(1)(b) (1985), and involuntary, which usually means “reckless,” *see, e.g.*, VA. CODE ANN. § 18.2-36 (Mitchie 1996); MODEL PENAL CODE § 210.3(1)(a) (1985). The two types of manslaughter are, in some states, also two different degrees of homicide. *See, e.g.*, COLO. REV. STAT. ANN. § 18-3-104-105 (West 1999). In Colorado, until recently, voluntary “heat of passion” manslaughter was punished as a Class 3 felony, while reckless manslaughter was punished as a Class 4 felony. In 1996, the crime previously known as “heat of passion” manslaughter became a form of second degree murder, albeit still punishable as a Class 3 felony. *Id.* § 18-3-103(b). Many states have some form of criminally negligent homicide. *See, e.g., id.* § 18-3-105; WASH. REV. CODE ANN. § 9A.32.070 (West 2000) (defining manslaughter in the second degree as causing the death of another person “with criminal negligence”). In states with the death penalty, the state is required to prove the highest form of culpable homicide plus one or more aggravating factors.

28. *See, e.g.*, WASH. REV. CODE ANN. § 9A.36.011 (West 2000) (first degree assault committed where defendant “with intent to inflict great bodily harm: [a]ssaults another with a firearm or any deadly weapon or by any force or means likely to produce great bodily harm or death”); *id.* § 9A.36.022 (second degree assault committed where defendant administers poison with intent to injure, inflicts grievous bodily harm, or assaults victim with a deadly weapon); *id.* § 9A.36.031 (defining third degree assault in several ways involving less harm and less dangerous weapons than required in first and second degree assaults). The weapon factor is a proxy for measuring blameworthiness as demonstrated by a willingness to inflict the sort of harm that can be caused by dangerous or deadly weapons.

29. ROLLIN M. PERKINS & RONALD M. BOYCE, CRIMINAL LAW, 290 (3d ed. 1982) (“Under the early law felonies were punishable by death, and larceny was a common-law felony.”) Professor Roger Groot, one of the leading authorities on Twelfth and Thirteenth Century English criminal practice, *see, e.g.*, Roger D. Groot, *The Jury of Presentment Before 1215*, 26 AM. J. LEGAL HIST. 1 (1982), has studied English plea rolls from Thirteenth Century and found a de facto division of larceny cases into offenses meriting hanging and those which did not predate the formal creation of grand and petit larceny categories in the Statute of Westminster of 1275. Professor Groot says that, as early as the 1240s, defendants often were not subjected to the normal criminal processes when they stole “petty things.” Roger D. Groot, *Petit, Larceny, Jury Lenity and Parliament*, in “THE DEAREST BIRTH RIGHT OF THE PEOPLE OF ENGLAND”: THE JURY IN THE HISTORY OF THE

By 1275, larceny was divided into grand and petit larceny depending on the value of the goods stolen; both crimes were felonies, but only the former was punished with death.<sup>30</sup> In the 1700s, Parliament enacted statutes creating the crimes of false pretenses<sup>31</sup> and embezzlement,<sup>32</sup> both of which were “misdemeanors” though punishable by penalties we would now consider appropriate for “felonies.”<sup>33</sup> Under modern codes, the various types of property crimes are generally consolidated into the single crime of “theft,” each of the old familiar categories becoming now but a different method of committing the same offense.<sup>34</sup> There are generally only two or three degrees of “theft,” with the primary distinction between the degrees being the value of the thing stolen.<sup>35</sup>

In addition, modern state penal codes include crimes such as robbery, burglary, or extortion that customarily involve stealing in some form.<sup>36</sup> These

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COMMON LAW (2001).

30. See PERKINS & BOYCE, *supra* note 29, at 335 nn.4-5.

31. 30 Geo. 2, c. 24, § 1 (1757) (Eng.).

32. 39 Geo. 3, c. 85 (1799) (Eng.).

33. See PERKINS & BOYCE, *supra* note 29, at 363-64 (describing the history of the law of false pretenses and quoting the first false pretenses statute as imposing penalties of fine, imprisonment, the pillory, public whipping, or transportation for seven years), at 352 n.6 (noting that the punishment for embezzlement under the 1799 statute was transportation not to exceed fourteen years).

34. WAYNE R. LAFAVE & AUSTIN W. SCOTT, JR., CRIMINAL LAW § 8.8(c), at 760-61 (2d ed. 1986); PERKINS & BOYCE, *supra* note 29, at 390-91.

35. For example, in Delaware, theft is either a Class G felony or a misdemeanor, depending on whether the property taken is worth more or less than \$500. DEL. CODE ANN. tit. 11, § 841 (1995) (theft may also be a Class F felony if the property is worth \$500 or more *and* the victim is 60 years of age or older). Washington divides theft into three degrees based primarily on the value of the thing taken. See WASH. REV. CODE ANN. § 9A.56.030(1)(a) (West 2000) (theft in the first degree, a Class B felony, is committed when value of property or services taken exceed(s) \$1500); *id.* § 9A.56.040(1) (theft in the second degree, a Class C felony, is committed when value of property or services taken is between \$250 and \$1500); *id.* § 9A.56.050(1) (theft in the third degree, a misdemeanor, is committed when value of property or services taken does not exceed \$250). In Washington, first and second degree theft are felonies; third degree theft is a misdemeanor. Colorado divides theft into four degrees based on the value of the thing taken; there are two felony and two misdemeanor classifications. COLO. REV. STAT. ANN. § 18-4-401 (West 2000).

Some states have special laws dealing with bad checks, receiving stolen property, and other variants of simple thievery. See, e.g., WASH. REV. CODE ANN. § 9A.56.060 (West 2000) (crime of unlawful issuance of bank checks is Class C felony when the amount of the check or checks exceeds \$250, but a misdemeanor if the amount is \$250 or less); *id.* §§ 9A.56.150, 9A.56.160, 9A.56.170 (the crimes of possession of stolen property in the first, second, and third degree are divided into same degrees as theft based on same dollar amounts). However, such offenses are customarily divided into the same number of degrees as is theft itself based on the amount of the bad check or the value of the stolen property. *Id.*; see also COLO. REV. STAT. ANN. § 18-4-410 (West 2000) (theft by receiving divided into same degrees as theft, based on the value of the stolen property received).

36. Burglary can be committed when the illegal entry is made for the purpose of committing



crimes are often divided by statute into degrees, but the focus of these offenses is less on economic harm than on invasions of other interests—the sanctity of the home, the risk of physical violence patent in every robbery and latent in every burglary,<sup>37</sup> and the threat to people, property, or reputation implicit in extortion. Accordingly, the factors establishing the relative seriousness of the statutory degrees of burglary, robbery, and extortion are almost exclusively non-economic. The difference between simple and aggravated robbery is the presence or absence of a weapon.<sup>38</sup> The difference between first and second degree burglary is most often the presence of a weapon or the commission of an assault during the crime.<sup>39</sup>

Notably absent from the ranking calculus of traditional common law and state statutory economic crimes is any consideration of mental state or of the nature and quality of the act(s) which make up the crime. Of course, proof of both a culpable mental state and some voluntary act in aid of the crime are prerequisites for the imposition of liability. However, the mental state necessary to almost all simple theft-type crimes is some variant of an intent to steal, defraud, or otherwise deprive the owner of the use or benefit of his property.<sup>40</sup> No effort has been made, at least by the drafters of statutes, to distinguish between more and less reprehensible conditions of larcenous intentionality. Similarly, theft-type statutes prohibit a host of means by which victims may be

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a non-property crime. *See, e.g.*, WASH. REV. CODE ANN. § 9A.52.020 (West 2000) (defining burglary). Similarly, extortion can involve obtaining either property or services by threat, including sexual favors. *See, e.g., id.* § 9A.56.110 (defining extortion).

37. *See* United States v. Couch, 65 F.3d 542, 545 (6th Cir. 1995) (observing that the federal sentencing guideline for burglary has a higher base offense level than the theft guideline because “criminal activity that takes place in a dwelling or structure carries with it an increased risk of encountering innocent people and causing physical and psychological injuries”).

38. *Compare, e.g.*, WASH. REV. CODE ANN. § 9A.56.200 (West 2000) (robbery in the first degree is committed when defendant is armed with or displays a deadly weapon or inflicts bodily injury), *with id.* § 9A.56.210 (“A person is guilty of robbery in the second degree if he commits robbery.”).

39. *Compare, e.g., id.* § 9A.52.020 (burglary in the first degree committed where defendant enters a dwelling and is armed with a deadly weapon or assaults any person therein), *with id.* § 9A.56.030 (burglary in the second degree committed if defendant, “with intent to commit a crime against a person or property . . . therein . . . enters or remains unlawfully in a building other than a vehicle or a dwelling”). *Compare* COLO. REV. STAT. ANN. § 18-4-202 (West Supp. 2000) (first degree burglary committed when defendant unlawfully enters a building or occupied structure with intent to commit a crime therein and assaults or menaces another person or is armed with a deadly weapon), *with id.* § 18-4-203 (second degree burglary committed when defendant breaks into, enters or remains unlawfully in a building with intent to commit a crime therein against another person or property).

40. JOSHUA DRESSLER, UNDERSTANDING CRIMINAL LAW § 32.07 (required mental state for larceny is intent to steal), § 32.09[B] (describing required mental state for embezzlement), § 32.10[C][3] (required mental state for false pretenses is intent to defraud).



relieved of their property, but method is not a factor in ranking such crimes.<sup>41</sup>

The consequence of this pattern of historical development is that there are a variety of well-developed, long-recognized statutory guideposts for distinguishing between more and less serious crimes against persons, but only one recognized, commonly codified determinant of the degrees of seriousness of economic crimes—the value of the thing stolen.

One might well ask why this simple, and seemingly simplistic, approach to categorizing economic crimes persisted in English law, and dominates the law of American states today. The probable answer is that it suited the theft cases that predominated in the developing law of England before very recent times, and which continue to predominate in most American state courts. As George Fletcher has observed, early theft law, both in England and on the European continent, concerned itself largely with cases of “manifest thievery”: that is, cases that look and feel like the paradigm of a thief seizing one’s goods by stealth and carrying them away.<sup>42</sup> Despite being the source of endless headaches to generations of judges, lawyers, and law students, the common law and early statutory crimes—larceny by trick, embezzlement, and false pretenses—that developed to fill perceived gaps in the early law of larceny<sup>43</sup> were nonetheless directed at conduct instinctively identifiable as stealing. Even today, the vast majority of “economic crimes” adjudicated in state courts remain very close to the classic model of manifest thievery or its early offshoots.<sup>44</sup> The defendant

41. See, e.g., the consolidated Colorado theft statute, COLO. REV. STAT. ANN. § 18-4-401 (West 1999), which prohibits direct taking of property from another, obtaining control over property by threat or by deception, knowing use, concealment, or abandonment of the property of another, and unlawfully demanding compensation for the return of another’s property, all within the same statute. *Id.*

42. George P. Fletcher, *The Metamorphosis of Larceny*, 89 HARV. L. REV. 469, 476-81 (1976) (describing the concepts of manifest thievery in Roman, biblical, early English, and other Indo-European legal traditions).

43. *Id.* at 502-20. See also GEORGE P. FLETCHER, RETHINKING CRIMINAL LAW §§ 2.1-2.4, 59-113 (1978).

44. Of the 989,007 inmates in the custody of state correctional authorities in 1995, 230,300 prisoners or 23.3% of the total population, were incarcerated for property offenses. BUREAU OF JUSTICE STATISTICS, CORRECTIONAL POPULATIONS IN THE UNITED STATES 9-10 tbl. 1.11, 1.12 (1997). Of this total, 10.9% were incarcerated for burglary, 4.8% for larceny, 2.6% for fraud, 2.2% for vehicle theft, and 2.7% for miscellaneous property crimes such as receiving stolen property, destruction of property, etc. *Id.* at 10 tbl. 1.12. Of the crimes reported to state police, larceny-theft offenses constitute over fifty percent of all the crimes in the following categories: murder, forcible rape, robbery, burglary, larceny-theft, and motor vehicle theft. See BUREAU OF JUSTICE STATISTICS, U.S. DEP’T OF JUSTICE, SOURCEBOOK OF CRIMINAL JUSTICE STATISTICS-1995, 349 tbl. 3.119 (1995); BUREAU OF JUSTICE STATISTICS, U.S. DEP’T OF JUSTICE, SOURCEBOOK OF CRIMINAL JUSTICE STATISTICS-1994, at 329 tbl. 3.103 (1994); BUREAU OF JUSTICE STATISTICS, U.S. DEP’T OF JUSTICE, SOURCEBOOK OF CRIMINAL JUSTICE STATISTICS-1993, at 375 tbl. 3.116 (1993). The average property loss (in dollars) incurred for larceny-theft excluding motor vehicle theft ranged from \$483 in 1993 to \$505 in 1995. *Id.*

stole a car, picked a pocket, tapped a till, wrote a dud check, or doctored the books, and it is easy to identify what was stolen, who it was stolen from, and how much it was worth. In these simple circumstances, the defendant's state of mind is patent and effectively indistinguishable from virtually all other such offenders, his methods are unremarkable, and so the value of the thing taken is not a bad proxy for the extent of the injury caused or threatened by the defendant's behavior, and thus for the relative seriousness of the crime.

By contrast, there are literally hundreds of federal economic crimes. Of the roughly 970 criminal statutes listed in Statutory Index to the 2000 Federal Sentencing Guidelines,<sup>45</sup> some 250 of them, or more than twenty-five percent, were sentenced using either the theft guideline, Section 2B1.1, or the fraud guideline, Section 2F1.1.<sup>46</sup> This total does not include the federal versions of crimes such as burglary,<sup>47</sup> robbery,<sup>48</sup> extortion,<sup>49</sup> blackmail,<sup>50</sup> bribery,<sup>51</sup> or criminal copyright infringement,<sup>52</sup> all of which are also crimes of dishonest acquisition.<sup>53</sup>

Federal economic crimes are not only numerous, they cover an immense range of disparate conduct and implicate an array of interests far beyond the interest of easily identifiable victims in readily quantifiable money, goods, or services. Federal criminal laws protect the integrity of commodities markets,<sup>54</sup> and prohibit the sale of unregistered securities through the mail.<sup>55</sup> They punish removal, disturbance, or destruction of the "graves, relics, or other evidences of an ancient civilization,"<sup>56</sup> and the removal of documents relating to claims against the United States.<sup>57</sup> They prohibit counterfeiting United States

45. The Statutory Index to the Guidelines, which appears at Appendix A, is a list of almost all the federal statutory provisions prescribing criminal penalties. It contains a separate entry for each separately chargeable statutory subsection. The list "specifies the guideline section(s) . . . ordinarily applicable to the statute of conviction." U.S.S.G., app. A (2000).

46. *Id.*

47. *Id.* § 2B2.1.

48. *Id.* § 2B3.1.

49. *Id.* § 2B3.2.

50. *Id.* § 2B3.3.

51. *Id.* § 2B4.1.

52. *Id.* § 2B5.3.

53. The Guidelines provisions for all of these crimes incorporate enhancements for "loss." See *id.* §§ 2B5.3(b)(1), 2B4.1(b)(1), 2B3.3(b)(1), 2B3.2(B)(2), 2B3.1(b)(7), 2B21(b)(2).

54. *E.g.*, 7 U.S.C.A. § 6 (West 2001) (restriction of commodities futures trading and foreign transactions).

55. 15 U.S.C.A. § 77e (West 2001) (making it unlawful to sell unregistered securities through the mail).

56. 16 U.S.C.A. § 114 (West 2001) (regarding the removal, disturbance, destruction, or molestation of ruins).

57. 18 U.S.C.A. § 285 (West 2001) (regarding taking or using papers relating to claims against the United States).



currency,<sup>58</sup> the obligations of foreign countries,<sup>59</sup> and the papers of ships.<sup>60</sup> More familiarly, federal law punishes theft and embezzlement from federally insured banks,<sup>61</sup> and criminalizes every "scheme or artifice to defraud" carried out by means of either the U.S. Mail<sup>62</sup> or interstate wire communications,<sup>63</sup> or directed at any "health care benefit program."<sup>64</sup>

Moreover, penalty levels for federal economic crimes vary widely and conform to no discernible pattern. The maximum penalties for federal economic crimes range from misdemeanor levels of a year or less,<sup>65</sup> to five years per count of conviction for wire and mail fraud,<sup>66</sup> to thirty years for bank fraud,<sup>67</sup> to life imprisonment for conducting a "continuing financial crimes enterprise."<sup>68</sup> These penalties are not tied to an overall ranking scheme, such as those nearly universal in state systems, where the legislature creates a limited set of offense categories ("Class 1" or "Class 2" or "Class 3" felonies, etc.) and then assigns every crime in the criminal code to one of the categories.<sup>69</sup> Such a scheme embraces all types of crime and incorporates legislative judgments about the relative seriousness of different offenses. Instead, the penalty ranges for federal economic offenses seem almost whimsical, owing more to the political enthusiasms of the moment they were enacted than any reasoned effort to compare the relative seriousness of different crimes.<sup>70</sup>

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58. *Id.* § 471 (prohibiting counterfeiting "any obligation or other security of the United States").

59. *Id.* § 480 (prohibiting making, altering, or counterfeiting with intent to defraud obligations of foreign governments).

60. *Id.* § 507 (prohibiting falsely making, forging, counterfeiting, or altering registries, licenses, passes, permits, and other ship's papers).

61. *Id.* § 656 (regarding theft, embezzlement or misapplication by bank officer or employee).

62. *Id.* § 1341 (prohibiting mail fraud).

63. *Id.* § 1343 (prohibiting wire fraud).

64. *Id.* § 1347 (prohibiting knowingly and willfully executing or attempting to execute a scheme or artifice to defraud any health care benefit program).

65. *Id.* § 656 (providing that penalty for embezzlement of less than \$1000 by a bank employee or officer shall be a fine, imprisonment for not more than one year, or both).

66. *Id.* §§ 1341, 1343.

67. *Id.* § 1344 (providing that penalty for bank fraud shall be a \$1 million fine, or thirty years imprisonment, or both).

68. *Id.* § 225(a) (prohibiting organizing, managing, or supervising a continuing financial crimes enterprise).

69. *See, e.g.,* COLO. REV. STAT. ANN. § 18-1-105 (West 2000) (classifying felonies into six classes) and § 18-1-106 (West 2000) (classifying misdemeanors into three classes); WASH. REV. CODE ANN. § 9A.20.010 (West 2000) (classifying felonies into three classes and misdemeanors into two classes).

70. A notable recent example of the effect of current events on federal criminal sentences is the fourfold, then sixfold, increase in the maximum penalty for bank embezzlement, from five years to twenty years in 1989, and from twenty years to thirty years in 1990, enacted by a Congress in the grip of the savings and loan debacle of the 1980s. *Compare* Act of June 25, 1948, ch. 645, 62 Stat.



The void created by the absence of meaningful congressional guidance on questions of relative offense seriousness is compounded by yet another condition common in federal economic crime prosecutions. Statutory structures, state and federal, for crimes against persons have a marked cabining effect on sentences in large part because a conviction for such offenses is likely to be of a single count—one murder, one assault, one rape, one robbery. Where there are multiple counts of conviction for crimes against persons, they have a tendency to merge for sentencing purposes, or, when they do not, there are likely to be distinctly different harms being punished—two dead victims if there are two counts of homicide, two robbed stores if there are two counts of robbery. The relationship between the number of counts of conviction and the number of discretely identifiable harms is much more blurred in federal white collar cases. The most notable examples are wire and mail fraud, offenses in which every separate mailing or interstate wire communication in furtherance of the criminal scheme is a separately indictable and punishable offense.<sup>71</sup>

By way of illustration, if a state legislature decides that the appropriate penalty range for one second degree murder is twelve to twenty-four years, the sentencing judge is probably going to be limited to a sentence within that range, and be precluded from sentencing the defendant to more than twenty-four years (a penalty range the legislature thought it was reserving for, say, first degree murder). The judge will be equally constrained from sentencing the defendant to less than twelve years, a range the legislature thought appropriate for various forms of manslaughter.<sup>72</sup> In contrast, until the advent of the Federal Sentencing Guidelines, the length of possible sentence faced by a federal white collar offender ran from a minimum of probation to a maximum term of imprisonment calculated by multiplying the number of counts of conviction times the maximum statutory sentence for each such count.<sup>73</sup> Thus, at least prior to the Guidelines,

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683, 729 (1948) (codified as amended at 18 U.S.C.A. § 656 (West 2001)) (setting maximum sentence for theft, embezzlement, or misapplication by bank officer or employee at five years imprisonment and a \$5000 fine), *with* Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 961(b), 103 Stat. 183, 499 (1989) (increasing maximum fine for violation of § 656 from \$5000 to \$1 million, and maximum term of imprisonment from five years to twenty years), *and* Crime Control Act of 1990, Pub. L. No. 101-647, § 2504(b), 104 Stat. 4789, 4861 (1990) (increasing maximum term of imprisonment for violation of § 656 from twenty years to thirty years).

71. 18 U.S.C.A. § 1341 (West 2001); *United States v. Clevenger*, 458 F. Supp. 354, 359 (E.D. Tenn. 1978) (holding separate counts for separate mailings in furtherance of same scheme to defraud not multiplicitous); *United States v. Brodbeck*, 430 F. Supp. 1056, 1060 (E.D. Wis. 1977) (same). *See also* *United States v. Calvert*, 523 F.2d 895, 914 (8th Cir. 1975) (each separate use of wire communication in aid of same scheme to defraud is separate offense).

72. This assumes a sentencing structure employing statutory ranges with minima and maxima. If there were no minima, the top-end constraints would still exist.

73. *See, e.g., United States v. Perez*, 956 F.2d 1098, 1102-03 (11th Cir. 1992) (affirming the power of a district court to impose consecutive sentences for convictions of burglary and theft arising from the same transaction).

the apparent legislative judgment about offense seriousness implicit in the decision to set five years as the maximum sentence for one count of a crime such as wire fraud disintegrated in the face of untrammelled prosecutorial discretion to charge one count or fifty arising from the same scheme, and the equally unlimited power of the judge to sentence anywhere in a legally permissible range that could run from zero to 250 years.

Thus, when the United States Sentencing Commission set out to create guidelines for sentencing economic criminals, it faced an array of difficulties greater than that presented by virtually any other category of offender.

2. *The Original Guidelines' Approach to Economic Crimes.*—The issues addressed by the Guidelines fall broadly into two categories: first, issues common to all offenders regardless of their particular offense, and second, issues specific to particular offenses. The first category addresses the treatment of criminal history,<sup>74</sup> the multiple count rules,<sup>75</sup> relevant conduct,<sup>76</sup> adjustments for the defendant's role,<sup>77</sup> adjustments for vulnerable victims,<sup>78</sup> and the virtual exclusion of the defendant's personal circumstances and characteristics from the calculation of guideline range.<sup>79</sup> The second category contains all the rules concerning the offense(s) for which the defendant is being sentenced. These are found in Chapter Two, "Offense Conduct."<sup>80</sup>

The Commission's approach to drafting Chapter Two guidelines for particular crimes was empirical and historical, rather than normative and philosophical. That is, with a few notable exceptions, the Commissioners did not attempt to determine what the penalty for any given offense *should be*; rather, they set out to reproduce the sentencing patterns in existence before the Guidelines.<sup>81</sup> The Commission studied a sample of 10,000 past cases to determine what sentences were rendered and why.<sup>82</sup> The objective was to identify the characteristics of both offenders and offenses that judges had historically deemed important in making sentencing choices. In effect, the Commission attempted to discover the federal common law of sentencing and

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74. See U.S.S.G., ch. 4 (2000).

75. See *id.* ch. 3, pt. D.

76. See *id.* § 1B1.3.

77. *Id.* § 5H1.7.

78. *Id.* § 3A1.1.

79. *Id.* ch. 5, pt. H.

80. *Id.* ch. 2.

81. The most prominent exception to the general approach of attempting to reproduce pre-Guidelines sentence levels was narcotics sentences, where, largely in response to statutory mandates, the Commission created a structure which dramatically increased drug sentences. See generally Bowman, *supra* note 7, 733-34, 740-46 (discussing drug sentences under the Guidelines and arguing that they are, in general, too long). See also Frank O. Bowman, III & Michael Heise, *Quiet Rebellion? Explaining Nearly a Decade of Declining Federal Drug Sentences*, 86 IOWA L. REV. 1043, 1067-1126 (2001) (attempting to explain why the average federal narcotics sentence declined significantly between 1992 and 1999).

82. Breyer, *supra* note 7, at 7 n.50.



codify it.

In the case of economic crimes, the original Commission adhered to its historical approach in some respects, but diverged from it in others. On the one hand, the Commission consciously chose to raise sentencing levels for economic crimes over pre-Guidelines levels.<sup>83</sup> The commissioners were plainly concerned that probationary sentences had been too common in economic crimes,<sup>84</sup> and that the Guidelines' objectives would be better served by the imposition of "short but certain terms of confinement for many white-collar offenders . . ."<sup>85</sup> On the other hand, the Commission did attempt to ascertain the factors that had historically been important in sentencing economic crimes, and to incorporate their findings in the Chapter Two offense conduct guidelines for such crimes.

In my view, the original Commission was correct to raise sentences for economic crimes above their *de minimis* historical levels.<sup>86</sup> However, its effort to identify sentencing factors federal judges had in the past found determinative for economic crimes produced rather lean results. Indeed, the Commission mentioned only two such factors in the commentary to the guidelines governing theft and fraud—the amount of the loss, and the amount and sophistication of planning activity involved in the crime.<sup>87</sup>

83. *Id.* at 20-21; Marvin E. Frankel, *Sentencing Guidelines: A Need for Creative Collaboration*, 101 YALE L. J. 2043, 2047 (1992) ("[T]he Commission produced guidelines that actually increase the overall severity [of federal sentences] taking particular aim at so-called white-collar offenders whom the Commission found (perhaps correctly) to have been treated with undue solicitude.").

84. As Justice Breyer, then a member of the Sentencing Commission, put it in 1988, "A pre-Guidelines sentence imposed on these criminals would likely take the form of straight probationary sentences." Breyer, *supra* note 7, at 7 n.49. See also John Hagan & Ilene Nagel Bernstein, *The Sentence Bargaining of Upperworld and Underworld Crime in Ten Federal District Courts*, 13 LAW & SOC'Y REV. 467, 475 (1979) (quoting an Assistant U.S. Attorney regarding office policy of vigorous advocacy in white-collar sentencing hearings "because unless we did [advocate strongly for imprisonment] almost everybody would walk out on probation").

85. Breyer, *supra* note 7, at 20.

86. See Bowman, *supra* note 7, at 734-41 (supporting the Commission's choice to increase economic crime sentences, and arguing that, even under the Guidelines, federal white collar sentences are often too low).

87. In the commentary to the former fraud guideline, the Commission observed: Empirical analyses of pre-guidelines practice showed that the *most important factors* that determined sentence length were the amount of loss and whether the offense was an isolated crime of opportunity or was sophisticated or repeated. Accordingly, although they are imperfect, *these are the primary factors upon which the guideline has been based.*

U.S.S.G. § 2F1.1, app. background (2000) (emphasis added).

The commentary to the former theft guideline states:

The value of the property stolen plays an important role in determining sentences for theft and other offenses involving stolen property because it is an indicator of both the harm to the victim and the gain to the defendant . . . The guidelines provide an



For the purpose of drafting guidelines, the original Sentencing Commission divided federal economic crimes into two basic types: crimes involving “the most basic forms of property offenses: theft, embezzlement, transactions in stolen goods, and simple property damage or destruction”<sup>88</sup> sentenced under Section 2B1.1,<sup>89</sup> and fraud crimes, sentenced under the provisions of Section 2F1.1. Then, having gone to the trouble of creating the distinction between theft on the one hand and fraud on the other, the Commission drafted two virtually identical guidelines, both of them based primarily on the amount of “loss” resulting from the defendant’s criminal conduct.<sup>90</sup>

The term “loss” was not defined in the text of the former theft and fraud guidelines.<sup>91</sup> Rather, it was discussed and defined in the commentary to those guidelines. The primary definition of “loss” appeared in Application Note 2 to the theft guideline, Section 2B1.1. The heart of the definition was this: “‘Loss’ means the value of the property taken, damaged or destroyed.”<sup>92</sup> The fraud guideline, Section 2F1.1, incorporated this definition, stating: “Valuation of loss is discussed in the Commentary to § 2B1.1 (Larceny, Embezzlement, and Other Forms of Theft). As in theft cases, loss is the value of the money, property, or services unlawfully taken . . . .”<sup>93</sup>

Application Note 7 to Section 2F1.1 went on to state: “*Frequently*, loss in a fraud case will be the same as in a theft case.”<sup>94</sup> This language raised but did

enhancement for more than minimal planning, which includes most offense behavior involving affirmative acts on multiple occasions. Planning and repeated acts are indicative of an intention and potential to do considerable harm. Also, planning is often related to increased difficulties of detection and proof.

*Id.* § 2B1.1, app. background.

88. *Id.* ch. 2, pt. B(1), introductory app.

89. Property damage cases were nominally sentenced under Section 2B1.3, but the core of that guideline was a cross-reference to Section 2B1.1 incorporating the loss table of Section 2B1.1(b)(1).

90. *See* U.S.S.G. §§ 2B1.1, 2F1.1 (2000).

91. The word “loss” appeared in guideline text only as a description of the monetary increments in two tables (§ 2B1.1(b)(1) and § 2F1.1(b)(1)) which gave rise to increases in offense level. *See id.* § 2B1.1(b)(1) (2000): “If the loss exceeded \$100, increase the offense level as follows: [followed by a table].”

92. *Id.* § 2B1.1, app. n.2 (emphasis added). Application Note 2 goes on to say:

Ordinarily, when property is taken or destroyed the loss is the fair market value of the particular property at issue. Where the market value is difficult to ascertain or inadequate to measure harm to the victim, the court may measure loss in some other way, such as reasonable replacement cost to the victim. Loss does not include the interest that could have been earned had the funds not been stolen. When property is damaged, the loss is the cost of repairs, not to exceed the loss had the property been destroyed.

*Id.* The note then discusses several examples and special cases. *Id.*

93. *Id.* § 2F1.1, app. n.8 (emphasis added).

94. *Id.* (emphasis added).

not answer the question of *when* loss in fraud cases would be the same as loss in theft cases.<sup>95</sup> The commentary to the former fraud guideline set out a number of special rules for particular cases, such as product substitution cases,<sup>96</sup> fraudulent loan and contract procurement cases,<sup>97</sup> procurement fraud,<sup>98</sup> government program benefits,<sup>99</sup> and Davis-Bacon Act cases.<sup>100</sup> Under both the former theft and fraud guidelines, “the loss need not be determined with precision. The court need only make a reasonable estimate of the loss, given the available information.”<sup>101</sup> Finally, the general rule for both theft cases under Section 2B1.1 and fraud cases under Section 2F1.1 was that the court should use the greater of actual or intended loss, if the intended loss was different than the actual loss and could be determined.<sup>102</sup>

## II. THE CASE FOR REFORM

### A. Consolidation of the Former Theft and Fraud Guidelines

From the inception of the guidelines system, the existence of one guideline

95. For further discussion of this issue, see *infra*, notes 269-89 and accompanying text.

96. U.S.S.G. § 2F1.1, app. n.8(a) (2000).

97. *Id.* § 2F1.1, app. n.8(b).

98. *Id.* § 2F1.1, app. n.8(c).

99. *Id.* § 2F1.1, app. n.8(d).

100. *Id.* § 2F1.1, app. n.8(e).

101. *Id.* § 2B1.1, app. n.3; *id.* § 2F1.1 app. n.9.

102. This rule was plainly stated only in the application notes to former § 2F1.1 concerning fraud cases: “Consistent with the provisions of § 2X1.1 (Attempt, Solicitation, or Conspiracy), if an intended loss that the defendant was attempting to inflict can be determined, this figure will be used if it is greater than the actual loss.” *Id.* § 2F1.1, app. n.8. Nonetheless, the same principle seems implicit in the examples used for illustration in the former theft guideline:

Examples: (1) In the case of a theft of a check or money order, the loss is the loss that would have occurred if the check or money order had been cashed. (2) In the case of a defendant apprehended taking a vehicle, the loss is the value of the vehicle even if the vehicle is recovered immediately.

*Id.* § 2B1.1, app. n.2.

The concept of intended loss was explicitly imported into the theft guideline *only* in cases of attempt. The former theft guideline read:

In the case of a partially completed offense (*e.g.*, an offense involving a completed theft that is part of a larger, attempted theft), the offense level is to be determined in accordance with the provisions of § 2X1.1 (Attempt, Solicitation, or Conspiracy) whether the conviction is for the substantive offense, the inchoate offense (attempt, solicitation, or conspiracy), or both; *see* Application Note 4 in the Commentary to § 2X1.1.

*Id.* § 2B1.1, app. n.2. The base offense level for an attempted theft was determined by adding to the base offense level of the substantive offense “any adjustments from such guideline for any intended offense conduct that can be established with reasonable certainty.” *Id.* § 2X1.1(a).



for crimes involving “theft,” Section 2B1.1, and another for crimes involving “fraud,” Section 2F1.1, was the source of some of the confusion surrounding federal economic crime sentencing generally, and the loss concept in particular. In the end, it became clear that there was no good reason to have two separate guidelines for theft and fraud, and that there were compelling reasons to consolidate the two sections.

First, the distinction between theft and fraud is largely illusory. Although not all theft crimes are frauds, virtually every fraud could be charged as some form of theft. Federal law abounds with instances where the same course of thievery is chargeable under multiple statutes, some of which are called “frauds,” and some of which are traditional “theft-like” offenses.<sup>103</sup>

Second, even if it were possible to draw a meaningful distinction between thefts and frauds, it would only be useful to do so in writing sentencing guidelines if the objective were to generate different sentencing outcomes for the two categories of cases. However, the sentencing range under both the former theft and fraud guidelines was driven almost entirely by loss amount, and the loss tables in the two guidelines were virtually identical. Moreover, because the fraud guideline essentially adopted the “loss” definition from the theft guideline, application of either former Section 2B1.1 or Section 2F1.1 to the same set of facts customarily produced either the identical sentencing range, or a pair of ranges so close that the top of one approached or overlapped the bottom of the other.<sup>104</sup> Thus, in the overwhelming majority of cases, the existence of separate fraud and theft guidelines was merely a pointless duplication.

Third, the existence of separate theft and fraud guidelines was mischievous. Sections 2B1.1 and 2F1.1, and their commentary regarding “loss,” were *slightly* different. Consequently, creative litigants and judges tried to impute meaning into the differences, which often led to confusion.<sup>105</sup>

Throughout the long economic crime sentencing debate, there was little or no dissent from the view that the theft and fraud guidelines should be consolidated.<sup>106</sup> The Sentencing Commission explicitly acknowledged the

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103. See Frank O. Bowman, III, *Coping with “Loss”: A Re-Examination of Sentencing Federal Economic Crimes Under the Guidelines*, 51 VAND. L. REV. 461, 490-92 (1998) [hereinafter Bowman, *Coping with “Loss”*] (discussing the illusory character of the theft-fraud distinction in federal law).

104. The Sentencing Table is constructed so that the top of one sentencing range will overlap the bottom of the range two offense levels higher. U.S.S.G. ch. 5, pt. A (2000).

105. See, e.g., Bowman, *Coping with “Loss,”* *supra* note 103, at 493-97 (discussing the series of Third Circuit cases beginning with *United States v. Kopp*, 951 F.2d 521 (3d Cir. 1991), and running through *United States v. Badaracco*, 954 F.2d 928 (3d Cir. 1992), *United States v. Coyle*, 63 F.3d 1239 (3d Cir. 1995), and *United States v. Maurello*, 76 F.3d 1304 (3d Cir. 1996)); J. Phil Gilbert, *Statement on “Loss” on Behalf of the Judicial Conference Committee on Criminal Law*, 10 FED. SENT. REP. 128, 129 (1997).

106. The three arguments for consolidation set forth in the text were laid out to the Sentencing Commission at its first public hearing on loss and the theft and fraud guidelines. *U.S. Sentencing Commission October 1997 Hearing on the Definition of “Loss”: Excerpts*, 10 FED. SENT. REP. 157,



foregoing critique when it consolidated the theft and fraud guidelines as part of the 2001 economic crime package.<sup>107</sup> As this aspect of the 2001 economic crime package was non-controversial, it will receive no further detailed discussion in this Article.

### B. The "Loss" Conundrum

If the problems in federal economic crime sentencing had been limited to the superfluity of separate theft and fraud guidelines, the debate would have been a short one. Far more significant was the galaxy of difficulties whirling around the concept of "loss." As described above, when the original Sentencing Commission wrote guidelines for economic crimes, it made the idea of "loss" the linchpin of the enterprise.<sup>108</sup> In both the former theft and fraud guidelines the base offense level<sup>109</sup> resulting from conviction alone was very low (4 in theft cases,<sup>110</sup> and 6 in fraud cases<sup>111</sup>), while the offense level could increase by up to eighteen levels in fraud cases and twenty levels in theft cases, depending on the amount of "loss" found by the court.<sup>112</sup> More concretely, the maximum term of

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159 (James E. Felman, ed. and annotator, 1997) [hereinafter *1997 Hearing Excerpts*] (testimony of Professor Frank O. Bowman, III). No member of the Commission expressed any disagreement then or later. A consolidated economic crimes guideline was part of the first economic crime package published for comment by the Conaboy Sentencing Commission. 63 Fed. Reg. 602, 610-14 (Jan. 6, 1998). The CLC supported consolidation beginning in 1997. See Gilbert, *supra* note 105, at 129 (statement by then-Chair of CLC Sentencing Guidelines Subcommittee endorsing a common definition of loss in both theft and fraud cases). Commentary by probation officers was favorable, see Fred S. Tryles, *A Critique of the Operation of the Theft and Fraud Guidelines from the Perspective of One Probation Officer*, 10 FED. SENT. REP. 131 (1997), and neither the Justice Department nor the Practitioners Advisory Group (the official advisory body representing the defense bar in Sentencing Commission matters) ever expressed opposition to the principle of consolidation.

107. See Sentencing Guidelines for the United States Courts, 66 Fed. Reg. 30512, 30540 (June 6, 2001) (setting forth Sentencing Commission's reasons for consolidating theft and fraud guidelines).

108. See *supra* notes 83-102 and accompanying text. For a more complete explanation of the operation of the U.S. Sentencing Guidelines generally, and the guidelines on economic crimes in particular, see Bowman, *Coping with "Loss," supra* note 103, at 472-90.

109. The Guidelines measure offense seriousness on the vertical axis of a sentencing grid. U.S.S.G. ch. 5, pt. A (2000). The unit of measurement on this axis is an "offense level." The "base offense level" for a crime is the number of offense levels awarded simply for conviction of the basic crime covered by the particular guideline in question. A defendant's final offense level will be the product of a process of adding to or subtracting from the base offense level as a result of other factors present in the offense. In economic crimes, one of the principal such factors is the amount of "loss." See *id.*; see also Bowman, *Coping with "Loss," supra* note 103, at 472-90.

110. See U.S.S.G. § 2B1.1(a) (2000).

111. See *id.* § 2F1.1(a).

112. See *id.* §§ 2B1.1(b), 2F1.1(b).

imprisonment a judge could impose on a first-time fraud offender based on the fact of conviction alone would be six months,<sup>113</sup> but that sentence could increase to more than five years based solely on the amount of loss.<sup>114</sup>

In the years following the Guidelines' adoption, the loss calculation became one of the most commonly litigated issues in federal sentencing law. Because the loss measurement is a primary determinant of sentence length in all crimes of dishonest acquisition, federal district court judges have been obliged to make loss findings in more than 9000 cases every year.<sup>115</sup> There are more than 1200 reported federal court opinions that discuss the loss finding in some way.<sup>116</sup> In addition to the sheer number of opinions on loss, disputes over the meaning of the term produced numerous splits of opinion between the federal circuits.<sup>117</sup> Perhaps even more significant than either the volume of litigation or the number of identifiable circuit splits was the overall sense of uncertainty, confusion, and sheer aggravation that emerged whenever lawyers and judges who dealt with federal white collar crime discussed loss.<sup>118</sup> An indication of this frustration can

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113. *Id.* § 5A.

114. *See id.* §§ 2F1.1(b), 5A. The increase in maximum available guidelines sentence from six months to five years posited in the text assumes a first-time offender convicted of fraud with a resulting base offense level of 6 who stole \$80 million, the maximum amount on the loss table. It also assumes no other adjustments to offense level other than that for "loss" amount.

115. Loss calculations are required in all fraud, larceny, and embezzlement cases, *see id.* §§ 2B1.1, 2F1.1. In 1999, federal judges sentenced 6144 fraud defendants, 2067 larceny defendants, and 949 embezzlement defendants. 1999 SOURCEBOOK, *supra* note 5, at 24, tbl. 11. In addition, loss calculations are often necessary in burglary and robbery cases, *see* U.S.S.G. §§ 2B2.1, 2B3.1 (2000). In 1999, federal courts sentenced 1771 robbery defendants, and fifty-three burglary defendants. 1999 SOURCEBOOK, *supra* note 5, at 24, tbl. 1.11. Thus, somewhere between 9000 and 11,000, or sixteen to twenty percent, of the 54,903 federal cases sentenced in 1999 required a determination of "loss." *See id.* This proportion has held roughly steady for some years. *See, e.g.,* 1995 ANNUAL REPORT, *supra* note 5, at 60, tbl. 18.

116. For example, a Westlaw search conducted on November 11, 2000 revealed over 1200 federal cases in which loss under Guideline Section 2B1.1 or 2F1.1 is at least mentioned. As of the same date, there were *at least* 300 officially reported federal appellate decisions under Section 2F1.1 *alone* in which the amount of loss was an issue of sufficient moment that the opinion discussed it in detail. *See* ROGER W. HAINES, JR. & JENNIFER C. WOLL, FEDERAL SENTENCING GUIDE § 305 (CD-rom Edition 1, 2000) (The Federal Sentencing Guide provides one-paragraph summaries of significant sentencing issues decided in published opinions by federal courts of appeals. It does not summarize sentencing decisions in district court cases or in unpublished, though publicly available, appellate opinions.)

117. *See* Bowman, *Coping with "Loss," supra* note 103, at 464 n.3. In its statement of reasons for the 2001 economic crime amendments, the Sentencing Commission lists a number of the circuit splits resolved by the amendments. *See* Sentencing Guidelines for United States Courts, 66 Fed. Reg. 30512, 30541-45 (June 6, 2001) [hereinafter Statement of Reasons] (setting forth Sentencing Commission's reasons for adoption of economic crime package).

118. *See, for example, United States v. Kaczmariski*, 939 F. Supp. 1176, 1182 n.7 (E.D. Pa. 1996), in which Judge Dalzell refers with obvious exasperation to the task of "construing the



be found in a 1996 survey by the Federal Judicial Center of the attitudes toward the Guidelines of federal judges and probation officers.<sup>119</sup> The Federal Judicial Center asked judges and probation officers to rate the clarity of the twelve most commonly used guidelines. Clarity was defined as the “degree to which the terms and definitions in the guideline are understandable.”<sup>120</sup> Both groups rated the fraud guideline (which, as we have seen, pivots on the definition of loss) second to last in clarity.<sup>121</sup>

Why has loss proven to be such a problem? No one disputes the notion that stealing more is worse than stealing less. Similarly, almost no one disagrees with the basic judgment at the heart of both the former and newly adopted economic crime guidelines that the sentences of thieves and swindlers should be determined in some significant part by the magnitude of the economic deprivations they caused or intended.<sup>122</sup> Where the Commission fell short between 1987 and 2001 was in the translation of a sound fundamental intuition into a just, doctrinally coherent, easy-to-apply set of rules.

The root of the loss problem was that the former theft and fraud guidelines did not contain a meaningful definition of the term. The descriptive commentary regarding loss following Sections 2B1.1 and 2F1.1 included a series of directives that neither singly nor together amounted to a coherent definition. The basic definition of loss announced in the theft guideline<sup>123</sup> and adopted by reference into the fraud guideline<sup>124</sup>—“the value of the property taken, damaged, or destroyed”<sup>125</sup>—used the language of larceny. The word “taken” is a term of art, denoting to an Anglo-American criminal lawyer the “taking” element of common law larceny, with its insistence on a transfer of possession of moveable personalty.<sup>126</sup> Outside the limited context of simple larceny-like offenses, this definition was virtually useless. For example, if “taken” retained some vestige of its common law meaning, when was property “taken” in a wire fraud or a check kite or a bankruptcy fraud or an insider trading case? And how? And from

vaporous word loss.” *Id.* The Second Circuit describes “loss” more circumspectly as “a flexible, fact-driven concept. . . .” *United States v. Jacobs*, 117 F.3d 82, 95 (2d Cir. 1997) (quoting *United States v. Dickler*, 64 F.3d 818, 825 (3d Cir. 1995)).

119. MOLLY TREADWAY JOHNSON & SCOTT A. GILBERT, FEDERAL JUDICIAL CENTER, THE U.S. SENTENCING GUIDELINES, RESULTS OF THE FEDERAL JUDICIAL CENTER’S 1996 SURVEY, REPORT TO THE COMMITTEE ON CRIMINAL LAW OF THE JUDICIAL CONFERENCE (1997).

120. *Id.* at 18.

121. *Id.* at 19.

122. There is, however, disagreement over the *degree* to which numeric measurements of economic harm should drive economic crime sentences. See, e.g., Jon O. Newman, *Toward Guidelines Simplification*, 13 FED. SENT. 56 (2000) (arguing that the influence of loss amount on sentence length should be substantially decreased). This issue will be addressed further below. See *infra* notes 137-45 and accompanying text.

123. U.S.S.G. § 2B1.1, app. n.2 (2000).

124. *Id.* § 2F1.1, app. n.8.

125. *Id.* § 2B1.1, app. n.2.

126. See DRESSLER, *supra* note 40, § 32.04, at 510.

whom? Alternatively, if “taken” was intended to invoke no particular doctrinal association, what did it mean?

Aside from the larceny-based core definition, perhaps the most glaring definitional defect in the former loss rules was their treatment of causation. The former theft and fraud guidelines and the cases construing them created a puzzling patchwork, which looked roughly like this:

1. The relevant conduct guideline, Section 1B1.3, mandated a broad measurement of harm, saying that offense levels were to be determined based on “all harm[s] result[ing] from” a defendant’s own conduct, and thus apparently set up a rule of pure “but for” causation.<sup>127</sup>

2. By contrast, both the former fraud and theft guidelines defined loss narrowly as the “thing taken,” the corpus delicti of the crime.<sup>128</sup>

3. Moreover, former Section 2F1.1, Application Note 8(c), said only “direct damages” counted, and excluded “consequential damages.”<sup>129</sup> Both these terms are drawn from contract law and are difficult, if not impossible, to apply in the criminal context.<sup>130</sup> If “consequential damages” was given its customary contract law meaning, Application Note 8(c) excluded from loss even economic harms directly caused by defendant’s conduct and foreseeable to him.<sup>131</sup>

4. On the other hand, in cases of procurement fraud and product substitution, former Section 2F1.1, Application Note 8(c), specifically included in loss the “consequential damages” elsewhere excluded, if the loss was “foreseeable.”<sup>132</sup>

5. Likewise, under the “relevant conduct” rules, if a defendant has co-conspirators or other criminal cohorts, he is responsible for all harms that resulted from all of their “reasonably foreseeable acts and omissions” in furtherance of the crime.<sup>133</sup>

6. In loan fraud cases, pursuant to former Section 2F1.1, Application Note 8(b), the loss to banks caused by a drop in value of pledged collateral was a part

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127. See U.S.S.G. § 1B1.3 (2000).

128. See *id.* §§ 2B1.1, app. n.2, and 2F1.1, app. n.8.

129. See *id.* § 2F1.1, app. n.8(c).

130. For a complete discussion of the problems created by the importation into the Guidelines of the contract terms “direct damages” and “consequential damages,” see Bowman, *Coping with “Loss,”* *supra* note 103, at 511-22.

131. The modern test for whether some alleged economic harm caused by a breach of contract is classified as a “consequential damage” is whether the harm was reasonably foreseeable to the breaching party. JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 10-4 at 569 (4th ed. 1995); A. CORBIN, CORBIN ON CONTRACTS. § 1010, at 79 (1964); see also U.C.C. § 2-715(2)(a) (stating that a defendant would be liable for “any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know.”) If a harm to a contract plaintiff was reasonably foreseeable to the breaching defendant, then it is ordinarily recoverable by the plaintiff absent some special contractual provision excluding such recovery. See U.C.C. § 2-715 & cmt. 3 (1998).

132. U.S.S.G. § 2F1.1, app. n.8(c) (2000).

133. *Id.* § 1B1.3.



of the loss, regardless of whether it was foreseeable and despite the fact that such a loss is a classic “consequential damage.”<sup>134</sup>

7. Except in loan fraud cases, if a victim’s loss was genuinely attributable to several causes, there was no rule for determining what the causal nexus to a defendant’s conduct must be before the loss should be counted.

This list describes only some of the problems with measuring losses actually incurred, and deals not at all with the oddities of the former theft and fraud guidelines’ treatment of loss in wholly or partially completed offenses. In short, in place of a coherent definition of a concept central to the sentencing of more than one-fifth of all federal defendants,<sup>135</sup> the former theft and fraud guidelines presented judges and lawyers with a jumble of rules developed piecemeal over the first decade of guidelines experience about what loss meant in particular situations.

Finally, there existed a concern among some observers that loss, even if better defined, was too influential in the sentencing calculus. These critics were troubled that loss, by far the largest factor in setting an economic crime sentence, failed to account for other considerations that ought to be important in sentencing economic criminals.

### *C. Sentence Severity in Economic Offenses*

As noted above, the original Sentencing Commission consciously chose to set penalties for economic offenses above their pre-Guidelines levels.<sup>136</sup> Even so, to many observers, economic crime sentences still appeared quite low, both by comparison with sentences imposed for other offenses (particularly narcotics), and as measured by their moral seriousness and the damage they inflict on society.<sup>137</sup> Two points seemed particularly troubling. First, under the former guidelines, a defendant could steal a very substantial sum without being required to serve any prison time. For example, a first-time offender must have stolen more than \$70,000 before any sentence of imprisonment was mandated (and the amount rose to \$200,000 if the crime was a one-time occurrence involving only minimal planning).<sup>138</sup> Second, defendants who stole obscenely large amounts of

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134. See *id.* § 2F1.1, app. n.8(b).

135. In 1999, of the 55,408 offenders sentenced in the federal courts, roughly 11,000 were sentenced for the offenses of fraud, larceny, embezzlement, burglary, or robbery, all of which involve calculations of loss amount under the applicable guidelines. See 1999 SOURCEBOOK, *supra* note 5, at 12 tbl. 3; U.S.S.G. §§ 2B1.1, 2F1.1 (2000).

136. See *supra* notes 81-87 and accompanying text.

137. Bowman, *supra* note 7, at 740. See also Catharine Goodwin, *The Case for a New Loss Table*, 13 FED. SENT. REP. 7 (2000).

138. The result was the same whether the crime was a “theft” or a “fraud.” Compare U.S.S.G. § 2B1.1(b)(1)(I) (2000), with § 2F1.1(b)(1)(G) (2000). The \$70,000 figure assumes a “more than minimal planning” adjustment under either former Section 2B1.1(b)(4)(A) or Section 2F1.1(b)(2)(A) of the Guidelines; the \$200,000 figure assumes a simple crime with only one victim for which no such adjustment is required. Both figures assume a defendant who pleads guilty

money received strikingly low sentences. For example, a swindler who stole between \$20 million and \$40 million would, if he pled guilty, be sentenced to only thirty-seven to forty-six months.<sup>139</sup>

By contrast, many members of the defense bar saw no need to increase sentences even for high-loss defendants.<sup>140</sup> Moreover, a number of observers both in and out of the defense bar felt that the theft and fraud guidelines were too rigid for offenders who stole relatively small amounts, and that judges ought to be accorded more flexibility to impose probationary or alternative sentences on such offenders.<sup>141</sup>

In the end, a compromise was struck. The Commission adopted a new loss table for the newly consolidated economic crime guideline.<sup>142</sup> The new table both increased sentences for high-loss offenders, and reduced sentences for low-loss offenders. In addition, the new guideline omits the two-level “more than minimal planning” adjustments contained in both the former theft and fraud guidelines,<sup>143</sup> and the “scheme to defraud more than one victim” adjustment in the former fraud guideline.<sup>144</sup> Instead of requiring a factual determination on the existence of more than minimal planning or multiple victims in virtually every case, the new guideline builds the two levels into its loss table beginning with cases in which the loss exceeds \$120,000. The details of these adjustments, and the rationales for them, have been treated elsewhere.<sup>145</sup> In any event, the new table is what it is. For judges and lawyers, an archeological foray into how the particular numbers were chosen is likely to be of little practical use. Hence, the new loss table will receive only incidental mention in the balance of this Article.

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sufficiently early in the process to avail himself of the three-level reduction for acceptance of responsibility under Guideline Section 3E1.1(a), (b). Moreover, under the former guidelines, a first-time offender must have stolen more than \$20,000 before a judge was required to impose even intermediate conditions of confinement such as home detention, community confinement, etc. (a figure that rose to \$70,000 if the offense did not involve “more than minimal planning”). See *id.* § 2B1.1; ch. 5, pt. A.

139. This result assumes a first-time offender given a two-level “more than minimal planning” upward adjustment under Guideline Section 2F1.1(b)(2)(A) (2000), and a three-level acceptance of responsibility downward adjustment pursuant to Sections 3E1.1(a)-(b). See also *id.* ch. 5, pt. A.

140. Barry Boss, *Do We Need to Increase the Sentences in White-Collar Cases? A View from the Trenches*, 10 FED. SENT. 124 (1997) [hereinafter Boss, *Do We Need to Increase the Sentences in White-Collar Cases?*]; Barry Boss & Jude Wikramanayake, *Sentencing in White Collar Cases: Time Does Not Heal All Wounds*, 13 FED. SENT. 15 (2000); James E. Felman, *Comments of Practitioners' Advisory Group, Criminal Law Committee, and Probation Advisory Group on Proposed Changes to “Loss” Tables*, 13 FED. SENT. 19 (2000).

141. Goodwin, *supra* note 137, at 12.

142. U.S.S.G. § 2B1.1(b)(1) (2001).

143. *Id.* §§ 2B1.1(b)(4)(A), 2F1.1(b)(2)(A) (2000).

144. *Id.* § 2F1.1(b)(2)(B).

145. See Bowman, *Coping with “Loss,” supra* note 103, at 499-500 (discussing abolition of more than minimal planning adjustment); Goodwin, *supra* note 137, *passim* (discussing modifications to loss table).



### *D. Money Laundering*

Money laundering statutes were passed to address a phenomenon ancillary to all modern crimes committed for money—the ill-gotten gains must be transported and concealed from authorities, and criminals have learned to use the mechanisms and instruments of the modern financial system to accomplish these ends. The “laundering” of criminal proceeds not only facilitates the underlying offenses, but can be an evil in itself, leading to corruption of the financial institutions upon which legitimate modern commerce depends.<sup>146</sup> The money laundering problem is particularly acute in the narcotics trafficking area where narcotics traffickers have employed financial institutions to transform unwieldy stacks of drug cash into more readily transferrable and concealable forms of wealth. However, federal money laundering statutes do not distinguish between drug crimes and other offenses that generate illegal proceeds. The basic conduct prohibited is knowingly engaging in financial transactions involving funds believed to be derived from a long list of unlawful activities, including fraud and theft.<sup>147</sup>

The sentencing controversy involving money laundering arose from the conjunction of two facts. First, the original Guidelines set the penalties for money laundering quite high, with a base offense level of 20 or 23, depending on the particular statutory subsection under which the defendant was convicted, and additional upward adjustments based on the amount of money laundered.<sup>148</sup> Second, until now, the money laundering guidelines took no account of the sentence level for the crime that generated the laundered money. In consequence, a defendant who committed a \$70,000 fraud crime for which the sentence under Section 2F1.1 would be ten to sixteen months could receive a sentence of thirty-three to forty-one months if he happened to deposit or wire transfer the proceeds in or through a bank and the government elected to use such transactions as the basis of a money laundering charge.<sup>149</sup> Because it is virtually impossible to commit a fraud crime without engaging in one of the types of monetary transactions covered by the money laundering statutes, prosecutors have enjoyed the option of adding a money laundering charge to virtually any fraud indictment, thus racheting up the potential Guidelines penalty.<sup>150</sup>

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146. The most prominent example of the corrosive effects of money laundering on financial institutions and networks is the infamous *BCCI* case. See *United States v. BCCI Holdings (Luxembourg), S.A.*, 46 F.3d 1185 (D.C. Cir. 1995) (describing BCCI litigation and resolving claims of defendant bank's branches to forfeited funds); *United States v. BCCI Holdings (Luxembourg), S.A.*, 961 F. Supp. 287 (D.C. D.C. 1997) (holding that dealing with known rogue bank forecloses bona fide purchaser claim in forfeiture proceeding).

147. 18 U.S.C.A. § (1956 & 1994).

148. U.S.S.G. § 2S1.1(a)(b)(2) (2000).

149. See *id.* §§ 2F.1.1; ch. 5, pt. A; 25.1.1.

150. I speak here of the effect of money laundering counts on fraud penalties because fraud and theft are the subject of this Article. However, money laundering counts can also be used to

Critics complained about this state of affairs on at least three grounds. First, where the financial transaction characterized as money laundering is really nothing more than a necessary incident of an otherwise unremarkable fraud or theft, imposition of higher money laundering penalties circumvents the judgment of the Sentencing Commission about the appropriate punishment for economic crime. Second, because money laundering charges are actually brought and prosecuted to conviction in only a small fraction of the economic crime cases in which they might theoretically be applied,<sup>151</sup> like cases are being treated dissimilarly, at the discretion of local federal prosecutors. Third, even where money laundering charges are not included in the indictment, or if included are not prosecuted to conviction, the looming threat of such charges and the resultant higher penalty is said to give prosecutors unfair plea bargaining leverage.

### III. A PROCEDURAL HISTORY OF THE 2001 ECONOMIC CRIME PACKAGE: THE AMENDMENTS TO THE FORMER THEFT AND FRAUD GUIDELINES

The process that culminated in the theft and fraud components of the 2001 economic crime package had its genesis in the guidelines “simplification” initiative of former Sentencing Commission Chair Richard Conaboy.<sup>152</sup> Staff work on economic crime sentencing reform began in 1995.<sup>153</sup> In January 1997, the Commission promulgated issues for comment on economic crime sentencing reform.<sup>154</sup> In the late summer of 1997, the first comprehensive proposal for consolidating the theft and fraud guidelines and redefining “loss” in terms of principles of causation was circulated to the Commission and other interested

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increase sentences for other federal offenses, such as bribery or public corruption.

151. It is impossible to determine how many economic crime sentencings might have included money laundering counts had the government chosen to press the matter. However, national sentencing statistics are suggestive. In Fiscal Year 2000, 11,748 defendants were sentenced for larceny, fraud, embezzlement, forgery, counterfeiting, bribery, or tax offenses. U.S. SENTENCING COMM’N, 2000 SOURCEBOOK OF FEDERAL SENTENCING STATISTICS 28, tbl. 12 (2001) [hereinafter 2000 SOURCEBOOK.] Almost all the offenses in these categories can serve as predicate offenses for money laundering. *See* 18 U.S.C. § 1956(b)(7) (1994). In 2001, an additional 23,002 defendants were sentenced for drug trafficking offenses, which are also predicate offenses for money laundering. 2000 SOURCEBOOK, *supra*. Nonetheless, in 2000, only 980 defendants were sentenced for money laundering. *Id.*

152. Although in the beginning the review of economic crime guidelines was only one small part of an ambitious effort to simplify the Guidelines generally, the 2001 economic crime package ultimately proved to be the only concrete result of the Conaboy Commission’s simplification project.

153. *See* U.S. Memorandum of Frank O. Bowman, III, Special Counsel, U.S. Sentencing Commission, to Donald A. Purdy, Chief Deputy General Counsel, U.S. Sentencing Commission, Summary and Analysis of Judicial Interpretations of the Term “Loss” in U.S.S.G. §§ 2B1.1 and 2F1.1 (April 16, 1996) (on file with author).

154. 62 Fed. Reg. 152, 171-74 (1997).



participants in the economic crime sentencing debate.<sup>155</sup>

In 1997, the Commission held its first public hearings on economic crime sentencing reform.<sup>156</sup> Interestingly, although debate would continue for another four years, the basic issues were already fairly well defined by the time of these first hearings. The Justice Department, the Criminal Law Committee (CLC) of the Judicial Conference, and probation officers generally favored modifying the loss table to increase sentences for high-loss offenders,<sup>157</sup> while the defense bar opposed such increases.<sup>158</sup> There was little dissent from the idea that consolidating the theft and fraud guidelines would be desirable.<sup>159</sup> The tough questions were whether a wholesale rewrite of the economic crime sentencing

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155. The full proposal and analysis was later published as a law review article. See Bowman, "Coping with Loss," *supra* note 103; see also Frank O. Bowman, III, *Back to Basics: Helping the Commission Solve the "Loss" Mess with Old Familiar Tools*, 10 FED. SENT. REP. 115 (1997) [hereinafter Bowman, *Back to Basics*] (containing a condensed version of the reform proposal); Frank O. Bowman, III, *Appendix to Guest Editor's Observations: A Proposal for a Consolidated Theft/Fraud Guideline*, 10 FED. SENT. REP. 173 (1997) (containing the text of the proposed consolidated theft/fraud guideline).

156. A public hearing on changing the loss tables for the then-existing theft and fraud guidelines was held in the spring of 1997. See UNITED STATES SENTENCING COMM'N, *Public Hearing on Proposed Guideline Amendments* (Mar. 18, 1997), available at <http://www.ussc.gov/hearings.htm>, at 49-63 (testimony of Frederic H. Cohn, member of Sentencing Guidelines Committee of the New York Council of Defense Lawyers). Another "non-public" hearing on the loss table at which representatives of the Justice Department and the judiciary appeared was also held in the spring of 1997, see *1997 Hearing Excerpts*, *supra* note 106, at 159 (testimony of Judge Gerald Rosen at October 1997 Sentencing Commission hearing recalling another hearing "back in the spring" on the loss tables); however, no public record of these proceedings can be found. A hearing addressing the interlocking questions of changing the tables and rewriting the theft and fraud guidelines themselves was held in October 1997. Full transcripts of the October hearing and copies of the written statements of the witnesses can be obtained at the Sentencing Commission website, available at <http://www.ussc.gov/hearings.htm>. An edited transcript of the October hearing appears in the Federal Sentencing Reporter. See *1997 Hearing Excerpts*, *supra* note 106.

157. See Boss, *Do We Need to Increase the Sentences in White-Collar Crimes?*, *supra* note 140, at 124 ("Spearheading the movement to increase sentences in economic crime cases has been the Criminal Law Committee of the Judicial Conference."); *1997 Hearing Excerpts*, *supra* note 106, at 158 (testimony of Gregory Hunt, chair of the Probation Officers Advisory Group, noting that "probation officers were quite effusive about the streamlining and increased severity of the loss table and they wholeheartedly support its adoption").

158. Boss, *Do We Need to Increase the Sentences in White-Collar Crimes?*, *supra* note 140, at 127 ("By adopting either of the two current proposals, we are not only artificially and unnecessarily increasing the sentences in these economic crime cases, but also legitimizing as a sentencing baseline the draconian and irrational sentencing schemes in drug cases.").

159. See, e.g., Tyles, *supra* note 106, at 134 ("The Sentencing Commission has an opportunity to advance its goal of simplification by merging the current theft and fraud guidelines.").

rules generally, and the loss concept in particular, was really necessary,<sup>160</sup> and if so, additional questions posed whether the loss concept should remain at the heart of economic crime sentencing,<sup>161</sup> whether it needed to be redefined,<sup>162</sup> and whether any redefinition should be based on principles of causation.<sup>163</sup>

In January 1998, the Commission published for comment a comprehensive economic crime reform package that sought to consolidate the theft and fraud guidelines, revise the loss table, and redefine "loss."<sup>164</sup> This first officially proposed redefinition of loss, though still a work in progress, had already assumed the broad outlines that had been suggested in the October 1997 hearings and that would ultimately be adopted in April 2001. That is, actual loss was defined in terms of reasonably foreseeable harms resulting from the defendant's criminal conduct; the concept of intended loss was retained as a measurement of offense seriousness for wholly or partially uncompleted offenses; and a variety of special rules addressing particular problems of loss measurement were appended to the core loss definition.<sup>165</sup> Between January and April 1998, staff and outside groups continued to work on the package. In February 1998, Commission staff produced and circulated for comment a revised draft of the loss definition that had been published in January.<sup>166</sup> On March 5, 1998, the Commission held a public hearing on the pending economic crime proposals,<sup>167</sup>

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160. See, e.g., *1997 Hearing Excerpts*, *supra* note 106, at 157 (statement of Commission Chair Richard Conaboy, opening the hearing with the question, "Why should the Commission consider tackling this whole problem of the definition of loss?"); *id.* at 158, (testimony of Judge Gerald Rosen), 166 (statement of Commissioner Mary Harkenrider, ex-officio representative of the Justice Department, questioning whether anything more than "slight refinements" to the economic crime guidelines were required).

161. See *id.* at 158 (statement of James E. Felman, on behalf of the Practitioners Advisory Group, noting that, "[W]e agree that loss is the best starting point to determine the severity of the offense. We don't think loss is the only way to measure the severity of the offense and the offender's culpability—we just can't improve on it.").

162. *Id.* at 160 (testimony of Judge Gerald Rosen on behalf of the CLC, stating that, "I think the one consistent thing that we heard from all of us is that the core definition [of loss] needs to be redone.")

163. *Id.* at 159, 161, 162 (testimony of Professor Frank Bowman, urging that loss be redefined in terms of causation); *id.* at 163 (testimony of Judge Gerald Rosen on behalf of the CLC, agreeing that "any definition [of loss] ought to include the notions of causation, foreseeability and harm"). See also Frank D. Bowman, III: October 15, 1997 Hearing of the U.S. Sentencing Commission, available at <http://www.usc.gov/hearings/bowman.pfd>.

164. 63 Fed. Reg. 602-35 (Jan. 6, 1998). For a general discussion of the status of the evolving debate on economic crime sentencing reform as it existed in early 1998, see Bowman, *Back to Basics*, *supra* note 155, at 115.

165. *Id.*

166. This and several other working drafts are published in *The Final Redefinition of "Loss," Plus Five Preceding Drafts*, 13 FED. SENT. 43 (2000) [hereinafter *Final Redefinition*].

167. The March 5, 1998 hearing was held in San Francisco, California, in conjunction with the annual meeting of the White Collar Crime Section of the Criminal Justice Section of the



at which representatives of the Department of Justice,<sup>168</sup> the defense bar,<sup>169</sup> and the academy<sup>170</sup> testified. In April 1998, a revised version of the economic crime package came within one vote of obtaining the unanimous approval it required from the only four Commissioners then remaining.<sup>171</sup> The elements of the April 1998 package were quite similar to the ultimately successful 2001 package—consolidation of the theft and fraud guidelines, a revised loss table, a redefinition of “loss” in terms of causation (“reasonably foreseeable harms”), and a variety of special and ancillary rules. However, no further formal action was possible between 1998-99 because, by fall 1998, the terms of all the Commissioners had expired and the vacancies remained unfilled until December 1999.

Reconsideration of the loss definition was so plainly essential to any meaningful economic crime sentencing initiative that, even after it became clear that the dwindling Conaboy Sentencing Commission membership would be unable to bring reform to fruition, they arranged for the loss redefinition so nearly passed in April 1998 to be “field-tested” during the summer of 1998.<sup>172</sup>

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American Bar Association. *Key Issues: Reassessing Sentences for Federal Theft, Fraud and Tax Crimes*, United States Sentencing Commission, Public Hearing (Mar. 5, 1998) [hereinafter Mar. 5, 1998 Hearing Transcript], available at [http://www.ussc.gov/agendas/3\\_5\\_98/0305ussc.pfd](http://www.ussc.gov/agendas/3_5_98/0305ussc.pfd). Copies of the written statements of the witnesses can also be obtained at the Sentencing Commission website, available at [http://www.ussc.gov/agendas/hr3\\_98.htm](http://www.ussc.gov/agendas/hr3_98.htm).

168. Katrina A. Pflaumer & Mary C. Spearing, Testimony Before the United States Sentencing Commission, Mar. 5, 1998, available at [http://www.ussc.gov/agendas/3\\_5\\_98/dojfraud.htm](http://www.ussc.gov/agendas/3_5_98/dojfraud.htm) (setting out position of Department of Justice on pending economic crime proposals, including proposed loss table changes and the February 1998 staff draft loss definition). See also Mar. 5, 1998 Hearing Transcript, *supra* note 167, at 68 (oral testimony of Mary Spearing); *id.* at 75, 88 (oral testimony of Katrina Pflaumer).

169. T. Mark Flanagan, Prepared Statement to the United States Sentencing Commission, Mar. 5, 1998 Public Hearing, [http://www.ussc.gov/agendas/3\\_5\\_98/flanagan.htm](http://www.ussc.gov/agendas/3_5_98/flanagan.htm) (discussing the proposed loss redefinition published by the Commission in the January 1998 Federal Register and the February 1998 staff draft loss definition); David F. Axelrod, Statement to the United States Sentencing Commission, Mar. 5, 1998, available at [http://www.ussc.gov/agendas/3\\_5\\_98/axelrod.pfd](http://www.ussc.gov/agendas/3_5_98/axelrod.pfd) (discussing proposed amendments to special offense characteristic provisions of theft and fraud guidelines). See also Mar. 5, 1998 Hearing Transcript, *supra* note 167, at 55, 98 (oral testimony of Gerald H. Goldstein); *id.* at 61, 96 (oral testimony of David Axelrod); *id.* at 73 (oral testimony of Ephraim Margolin); *id.* at 85 (oral testimony of T. Mark Flanagan).

170. Frank O. Bowman, III, United States Sentencing Commission Hearing, Mar. 5, 1998, Prepared Statement, available at [http://www.ussc.gov/agendas/3\\_5\\_98/bowman98.pfd](http://www.ussc.gov/agendas/3_5_98/bowman98.pfd) (containing a detailed critique of the February 1998 staff draft loss definition), and Mar. 5, 1998 Hearing Transcript, *supra* note 167, at 100 (oral testimony of Frank O. Bowman, III).

171. The version of the loss redefinition considered by the Commission in April 1998 is reproduced in *Final Redefinition*, *supra* note 166, at 45.

172. UNITED STATES SENTENCING COMM’N, *A Field Test of Proposed Revisions to the Definition of Loss in the Theft and Fraud Guidelines: A Report to the Commission* (Oct. 20, 1998), available at <http://www.ussc.gov>.

The response to the proposed redefinition by the federal judges and probation officers who participated in the field test was overwhelmingly positive.<sup>173</sup> Consequently, even during the 1998-99 hiatus with no sitting Commissioners, the Commission staff, in consultation with interested outside groups, continued to work on refining the draft loss definition, with particular attention to feedback received during the field test. The staff produced a proposal for a revised definition in May 1999.<sup>174</sup> During 1999, work also continued on possible revisions of the loss table.

When the seven empty seats around the Sentencing Commission table were refilled in December 1999, the newly constituted Commission, under the chairmanship of Judge Diana Murphy, made continuation of the economic crime initiative a top priority. In October 2000, the Commission sponsored its *Third Symposium on Crime and Punishment in the United States: Symposium on Federal Sentencing Policy for Economic Crimes and New Technology Offenses* at George Mason University School of Law, Arlington, Virginia.<sup>175</sup> The first day of the symposium was devoted to discussion of problems in sentencing theft and fraud cases, particularly the problems in defining "loss."<sup>176</sup>

Work on the economic crime package continued following the symposium. In January 2001, the Commission published for comment a new set of economic crime reform proposals, including options for revising the loss table and for redefining "loss."<sup>177</sup> The Commission published two proposals for redefining "loss," a staff draft containing a number of options on each of the contested points, and a separate proposal submitted by the Committee on Criminal Law of the United States Judicial Conference.<sup>178</sup>

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173. *Id.*

174. *Final Redefinition*, *supra* note 166, at 47 (text of Proposed Loss Redefinition, May 1999 Staff Draft).

175. UNITED STATES SENTENCING COMM'N, *Third Symposium on Crime and Punishment in the United States: Symposium on Federal Sentencing Policy for Economic Crimes and New Technology Offenses* (Oct. 12-13, 2000) [hereinafter *Symposium Proceedings*]. Video webcasts of most of the Economic Crime Symposium proceedings can be viewed on the Sentencing Commission website, <http://www.ussc.gov>.

176. *Symposium Proceedings*, *supra* note 175, at 3-132. See also Frank O. Bowman, III, *Briefing Paper on Problems in Redefining "Loss,"* 13 FED. SENT. 22 (2000) (briefing paper on problems of "loss" definition provided to small group discussion leaders prior to the October 2000 Economic Crime Symposium); Transcript, *Plenary Session IV: Major Issues Related to Determination of "Loss" as a Measure of Offense Seriousness and Offender Culpability*, 13 FED. SENT. REP. 31 (2000) [hereinafter 2000 Symposium Transcript] (transcript of the plenary session of the Economic Crime Symposium at which the small group leaders summarized the results of their discussions on redefining "loss").

177. Sentencing Guidelines for the United States Courts, 66 Fed. Reg. 7962 (Jan. 26, 2001) [hereinafter January 2001 Commission Draft].

178. *Id.* at 7992-98. See also Letter of Hon. William W. Wilkins, Jr., Chair, Committee on Criminal Law of the Judicial Conference of the United States, to the Chair and Members of the U.S. Sentencing Commission (with attachments) (Nov. 9, 2000) (on file with author). For a detailed



The views of the CLC on loss and the economic crime package generally seem to have been particularly influential among the Commissioners.<sup>179</sup> The final proof of their influence came as the deadline for action in the 2000-01 amendment cycle approached. Preparatory to the Commission's March 2001 meeting, Commission staff prepared yet another draft of a reformed "loss" definition.<sup>180</sup> The March 2000 staff draft would have abandoned the foreseeability-based definition of loss that had been widely accepted since the 1998 field test, and suggested reinstating concepts such as "consequential damages" that (as will be discussed below<sup>181</sup>) generated much of the confusion under the former guidelines. At the March 2001 Commission hearing, the judges of the Sentencing Guidelines Subcommittee of the CLC submitted a written statement<sup>182</sup> and testified forcefully in favor of their own proposal. Shortly thereafter, the Commission voted to adopt the final economic crime package, including a reformed loss definition that conformed to the CLC proposal on almost every significant issue.

The final procedural point of interest regarding the 2001 economic crime package is that, following passage of the package, the Commission published a detailed explanation of the newly adopted rules.<sup>183</sup> This explanatory material is a welcome departure from prior practice, and will doubtless prove useful to judges and practitioners.

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discussion of the November 2000 CLC "loss" definition proposal, see Frank O. Bowman, III, *A Judicious Solution: The Criminal Law Committee Draft Redefinition of the "Loss" Concept in Economic Crime Sentencing*, 9 GEO. MASON L. REV. 451 (2000).

179. The CLC was an interested and active participant from the very beginning of the Sentencing Commission's consideration of economic crime sentencing reform. Representatives of the CLC testified at Commission hearings and were heavily involved in negotiations over the shape of the package formally presented to the Sentencing Commission in April 1998. See, e.g., *1997 Hearing Excerpts*, *supra* note 106, at 167 (testimony of Hon. Gerald Rosen before U.S. Sentencing Commission on behalf of the CLC); Gilbert, *supra* note 105, at 128 (statement by then-Chair of CLC Sentencing Guidelines Subcommittee endorsing a common definition of loss in both theft and fraud cases).

180. *Final Redefinition*, *supra* note 166, at 51 (Proposed Redefinition of "Loss": March 2001 Sentencing Commission Staff Draft).

181. See *infra* notes 207-29 and accompanying text.

182. Committee on Criminal Law, Judicial Conference of the United States, *Criminal Law Committee Comments on Proposed Changes to "Loss" Definition*, 13 FED. SENT. 41 (2000) ([hereinafter *CLC Comments*]).

183. Statement of Reasons, *supra* note 117 (setting forth Sentencing Commission's reasons for adoption of economic crime package).

#### IV. AN ANALYSIS AND CRITIQUE OF THE MOST IMPORTANT PROVISIONS OF THE 2001 ECONOMIC CRIME PACKAGE

##### A. *The Fundamental Choices*

The two most important decisions made in the course of the debate over the 2001 Economic Crime Package were, first, to retain “loss”—pecuniary harm to the victim—as the primary measure of offense seriousness in economic crime, and second, to redefine loss in terms of causation. Before examining the specifics of the amendments adopted by the Commission, it is important to consider these fundamental choices.

1. *The Retention of “Loss” as the Core Measurement of Offense Severity.*—A crime occurs when there is a volitional act attended by a culpable mental state and the act causes, or at least risks causing, a harm.<sup>184</sup> All these concepts—act, mental state, cause, and harm—are relevant both to the threshold question of the existence of criminal liability and to assessing offense seriousness for purposes of assigning appropriate punishment.<sup>185</sup> Throughout the long economic crime sentencing debate, the Commission wrestled with the concern that, in the case of completed economic crimes, heavy reliance on a quantitative measurement of loss to determine offense level overemphasizes harm to the near-exclusion of the other traditionally relevant components of offense seriousness, particularly those relating to the defendant’s culpable mental state. Conversely, the established rule for wholly or partially inchoate economic offenses that “loss” should be the greater of actual or intended loss<sup>186</sup> could be argued to overemphasize mental state at the expense of considerations of actual harm.<sup>187</sup> In the end, however, the Commission retained loss as the linchpin of economic crime sentencing. Although the Commission never explicitly set out its reasons for adhering to a loss-based model,<sup>188</sup> three considerations may have proven persuasive.

First, although actual loss (even when awkwardly defined as it was under the former Guidelines) plainly measures harm, it also serves as a gauge of the defendant’s guilty mind. The persistent historical impulse to rank property

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184. JEROME HALL, GENERAL PRINCIPLES OF CRIMINAL LAW 16-19, 185-90 (2d ed. 1960).

185. “[T]he assessment of harm caused by the defendant as a result of the crime charged has understandably been an important concern of the criminal law, both in determining the elements of the offense and in determining the appropriate punishment.” *Payne v. Tennessee*, 501 U.S. 808, 819 (1991).

186. See U.S.S.G. §§ 2B1.1, app. n.2 and 2F1.1, app. n.8 (2000).

187. The argument is that by treating an incomplete attempt to steal or swindle \$X as the equivalent of actually stealing \$X, the Guidelines overemphasize mental state in comparison to actual harm.

188. In its statement of reasons for adopting the economic crime package, the Commission addressed a number of the specific elements of the loss definition, but did not explain the fundamental choice to adhere to a loss-centered system. See Statement of Reasons, *supra* note 117, at 30540-42 (setting forth Sentencing Commission’s reasons for adoption of economic crime package).



crimes by the value of property stolen rests in part on a judgment about mental state. Recall that the mental state element of virtually all economic crimes is some variant of an intent to steal, defraud, or otherwise deprive the victim of the use or benefit of his property.<sup>189</sup> Thus, from the point of view of statutory law, all convicted thieves, embezzlers, and con artists are formally indistinguishable as regards *mens rea*. Even so, stealing more is worse than stealing less and merits greater punishment, not only because a larger loss inflicts a greater harm, but also because one who *desires* to inflict a large harm is customarily thought to have a more reprehensible condition of mind than one who desires to inflict a small one. To this extent, actual loss is not a bad proxy for mental state. (And, of course, intended loss is a direct measurement of culpable mental state.)

Second, careful study of the pre-reform economic crime guidelines reveals that they did not merely rely on either actual or intended loss as crude proxies for mental state, but had already identified and provided specific offense level adjustments for most of the factors relating to mental state traditionally thought important in the imposition of economic crime sentences. The only systematic study of federal sentencing practices for “white-collar” offenders was conducted by Wheeler, Mann, and Sarat in 1988, before the Guidelines’ promulgation, and surveyed federal judges about the sentences they gave economic criminals and the reasons for giving them.<sup>190</sup> The survey confirmed the original Sentencing Commission’s finding<sup>191</sup> that the amount of planning activity and the complexity of the criminal scheme are considered important by judges in sentencing.<sup>192</sup> The conclusion is unsurprising. In all types of crime, a defendant who plots, plans, and schemes to achieve an evil end is thought more culpable than one who causes the same harm on impulse. Moreover, Wheeler and his colleagues identified other factors—including leadership role within the criminal undertaking,<sup>193</sup> whether the defendant betrayed a position of trust,<sup>194</sup> indications of genuine contrition,<sup>195</sup> and cooperation with authorities upon apprehension<sup>196</sup>—that entered into judges’ sentencing decisions.

All of these considerations are related to assessments of mental state (as well as to other sentencing considerations such as assessment of future dangerousness, likelihood of rehabilitation, and harm to the community), and all are accounted for in the former Guidelines’ structure. Complexity of scheme and extent of planning activity were dealt with through the two-level upward adjustment for “more than minimal planning” included in both the former theft and fraud

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189. See *supra* note 40 and accompanying text.

190. STANTON WHEELER ET AL., SITTING IN JUDGMENT: THE SENTENCING OF WHITE-COLLAR CRIMINALS 1-5 (1988) (describing authors’ research methods).

191. *Supra* note 87 and accompanying text.

192. WHEELER ET AL. *supra* note 190, at 93-94.

193. *Id.* at 97-102.

194. *Id.*

195. *Id.* at 120-21.

196. *Id.*

guidelines.<sup>197</sup> The other listed considerations were (and continue to be) accounted for in guidelines applicable to all types of offenses. The defendant's role, as leader or follower, can generate upward or downward adjustments of up to four offense levels.<sup>198</sup> Abuse of a position of trust is penalized by a two-level upward adjustment.<sup>199</sup> Contrition is at least the ostensible subject of the "acceptance of responsibility" guideline.<sup>200</sup> The biggest potential sentencing rewards are reserved for defendants who provide "substantial assistance" to the government in investigating and prosecuting others.<sup>201</sup> These offense level adjustments prove on inspection to account for almost all the factors commonly thought relevant to assessing a financial felon's state of mind during the offense and after his apprehension. All of these adjustments, with the notable exception of the "more than minimal planning" provisions of the former theft and fraud guidelines, are retained in the revised economic crime guideline structure.<sup>202</sup>

One might nonetheless contend that, even though the Guidelines *identify* most of the factors other than loss relevant to assessing the relative seriousness of economic crimes, loss nonetheless receives undue *weight* in the sentencing calculus. After all, a defendant's offense level could be increased by up to twenty levels for amount of loss under the former theft guideline,<sup>203</sup> while the maximum increase or decrease for any of the other factors just listed was (and remains) four.<sup>204</sup> Part of the response to this argument is implicit in the very fact that loss serves multiple purposes. That is, actual loss is not only a direct measure of harm, but also an important proxy measurement of *mens rea*. Similarly, intended loss serves as a direct measurement of mental state, but also as a rough measure of the risk of real harm presented by the defendant's conduct.<sup>205</sup> Thus, loss, both actual and intended, properly looms larger than other

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197. U.S.S.G. § 2B1.1(b)(4)(A) (2000); *id.* § 2F1.1(b)(2)(A).

198. *Id.* §§ 3B1.1-1.2.

199. *Id.* § 3B1.3.

200. *Id.* § 3E1.1(a) (conferring two- or three-level offense level reductions where a defendant "demonstrates acceptance of responsibility for his offense"). Of course, realists with some experience of federal sentencing would doubtless say that the "acceptance of responsibility" credit has more to do with rewarding early guilty pleas and the resultant saving in governmental resources than it does with an assessment of contrition.

201. *Id.* § 5K1.1. See Bowman, *supra* note 7, at 722-24 (discussing sentence reductions for substantial assistance under § 5K1.1); Frank O. Bowman, III, *Departing is Such Sweet Sorrow: A Year of Judicial Revolt on "Substantial Assistance" Departures Follows a Decade of Prosecutorial Indiscipline*, 29 STETSON L. REV. 7 (1999).

202. As I will discuss below, *see infra* Part IV.H, the Commission addressed the deficiencies of "more than minimal planning" by abolishing that adjustment and substituting enhancement for "sophisticated means" and a graduated adjustment for number of victims.

203. U.S.S.G. § 2B1.1(b)(1)(U) (2000).

204. *Id.* §§ 3B1.1-1.2 (providing for four-level upward or downward adjustments for role in the offense).

205. Speaking broadly, a criminal defendant who intends to steal \$1 million, and though unsuccessful, engages in enough completed conduct to subject himself to criminal liability, presents



more narrowly focused sentencing factors.

Moreover, careful reflection on the Guidelines' structure further diminishes, if it does not entirely extinguish, the argument that undue weight is placed on loss. The Guidelines' Sentencing Table is logarithmic, with each increase of two offense levels representing an increase in minimum sentence length of six months or twenty-five percent, whichever is greater. Thus, a mere two-level adjustment for role in the offense, abuse of trust, acceptance of responsibility, or the like will increase or decrease the otherwise applicable sentence by at least twenty-five percent. For example, a defendant who stole \$100,000 from his employer, thus abusing a position of trust, would (under the former theft guideline) receive a sentence of ten to sixteen months based on the loss amount alone, but would see his minimum sentence increase by five months or fifty percent as a consequence of the two-level abuse of trust enhancement. If the loss were \$400,000, the abuse of trust enhancement would increase the defendant's minimum sentence thirty-three percent from eighteen to twenty-four months to twenty-four to thirty months. Viewed in this light, it is difficult to sustain the position that loss is overemphasized as compared to a factor like abuse of trust when such a factor increases by thirty-three to fifty percent a sentence that would be required by loss amount alone.<sup>206</sup>

The third and final consideration that may have cemented the Sentencing Commission's continued reliance on the loss measurement was that by redefining actual loss in terms of causation, the Commission was able to make loss a better proxy measurement of the defendant's guilty mind than it had been under the former definition. To see why this is so, let us consider the Commission's decision to adopt a causation-based definition of actual loss.

2. *The Decision to Define "Loss" in Terms of Causation.*—As described above,<sup>207</sup> the "definition" of actual loss scattered in bits and pieces through the commentary on the former theft and fraud guidelines was a hodgepodge—a core definition ("the value of the property taken, damaged, or destroyed"<sup>208</sup>) drawn from the common law of larceny combined with an apparent rule of causation derived by negative inference from the exclusion of a classification of harms ("consequential damages") drawn from civil contract law,<sup>209</sup> plus a gaggle of special rules. Virtually no one defended the old definition. The problem was to identify core principles upon which a new coherent definition could be based. More concretely, the difficulty was to define loss in a way that would account simultaneously for the amount of harm caused by the economic criminal's conduct and for the relationship between that harm and the defendant's state of mind.

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a greater risk to society than a defendant who commits the same quantum of culpable conduct but intends to steal only \$10,000.

206. Of course, the force of this argument depends to some degree on which you count first, loss or enhancements such as abuse of trust, role in the offense, etc.

207. See *supra* notes 127-35 and accompanying text.

208. U.S.S.G. § 2B1.1, app. n.2 (2000).

209. *Id.* § 2F1.1, app. n.8(c).

Even in completed offenses, the simple equivalency between harm inflicted and offense seriousness becomes more complex when the defendant's criminal conduct causes harms that the defendant did not specifically desire (even though he may have realized that they might well result), or from which he did not personally benefit. For example, a defendant in a fraudulent loan application case, hopeful that his "ship would come in" in time to make repayment, may not have intended that the bank lose its loan money. Or the author of a telemarketing scheme might not intend that his elderly victims lose their homes as a result of losing their retirement savings to the telemarketer. In these and many other cases, whether the defendant is to be held culpable for particular losses to victims, and thus whether the loss number and perhaps his offense level may be increased, will depend on the legal question of *causation*. In other words, was the causal link between the defendant's conduct and the harm that resulted sufficiently direct that the law should hold the defendant responsible and increase his punishment accordingly?

The literature of criminal law, contracts, and torts usually conceives of causation problems as having two components, customarily labeled "cause-in-fact" and legal cause.<sup>210</sup> Cause-in-fact is about determining the causal relationship between a defendant's act and a subsequent harm to another.<sup>211</sup> It asks whether the conduct truly was a part of the chain of events in the physical world that brought about the harm. Legal cause asks a different question: Assuming that the defendant's conduct truly did play a role in bringing about the harm, is it just to impose legal liability for the harm concededly caused?<sup>212</sup> For example, a hiker who dislodges a pebble on a mountainside may start an avalanche that obliterates a village below. Cause-in-fact is concerned only with the issue of whether the dislodged pebble started the avalanche. Legal cause is about whether, assuming that the pebble did cause the slide, the hiker should, as a matter of law and social policy, be held accountable and punished for the destruction of the village and the death of the villagers.

In both civil and criminal law, the most common causation standard is "reasonable foreseeability."<sup>213</sup> To a certain extent, the familiar reasonable foreseeability standard conflates the analytically distinct questions of cause-in-fact and legal cause. That is, under a reasonable foreseeability standard, a defendant will be held civilly liable or criminally culpable for harms that were caused in fact by defendant's conduct, in the sense that they would not have occurred but for defendant's conduct, and were, at the time of defendant's illegal conduct, foreseeable to a reasonable person in defendant's position. The former economic crime guidelines did not address the issue of causation of loss, except

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210. For an extended discussion of the problem of causation in economic crime sentencing, as well as the relationship of thinking about causation in other areas of the law to this problem, see Bowman, *Coping with "Loss,"* *supra* note 103, at 527-36.

211. *Id.* at 530-31.

212. *Id.* at 532-36.

213. *Id.*



indirectly.<sup>214</sup> The newly consolidated economic crime guideline not only addresses causation, but defines actual loss in causal terms. “Actual loss” will now mean “the reasonably foreseeable pecuniary harm that resulted from the offense.”<sup>215</sup>

The decision to define loss in terms of causation came only after the Commission considered and rejected a series of objections:

*a. Leaving causation undefined was not a viable option.*—From time to time during the loss debate, it was suggested that placing a causation standard in the loss definition was just too troublesome, and that the status quo should be maintained by omitting any reference to cause. This was not a tenable option. No coherent definition of loss is possible without a specification of the required causal nexus between the crime and economic harms that are to be counted as loss. Even if the Commission had ignored the question of causation, courts construing the economic crime guidelines do not have that luxury. The causation issue is latent in every loss determination, regardless of the prevailing formal definition of the term, and was the pivotal question in many cases under the old definition.<sup>216</sup> Moreover, a well-defined causation standard not only provides the immediate rule of decision in some number of cases, but serves as the central organizing principle against which special rules governing particular loss measurement problems should be measured.

*b. Reasonable foreseeability is the best available causation standard.*—There were those who, while conceding that some causal standard was doubtless necessary, remained skeptical of the particular standard—“but for” causation plus reasonable foreseeability—embodied in the 2001 economic crime

214. See *supra* notes 127-35 and accompanying text (describing the patchwork treatment of causation implied by current guidelines provisions, including the relevant conduct guideline); U.S.S.G. § 1B1.3 (2000); see also *id.* § 2F1.1, app. n.8(c) (inclusion of the contracts term “consequential damages”).

215. U.S.S.G. § 2B1.1, app. n.2(A)(i) (2001).

216. See, e.g., *United States v. Hicks*, 217 F.3d 1038 (9th Cir. 2000) (employing proximate cause analysis to determine loss), *cert. denied*, 531 U.S. 1037 (2000); *United States v. Neadle*, 72 F.3d 1104 (3d Cir. 1995) (discussing the necessary causal connection between the conduct of a defendant who lied about the undercapitalization of his insurance company and insurance losses sustained in the wake of Hurricane Hugo), *amended* 79 F.3d 14 (1996). See also *United States v. Yeaman*, 194 F.3d 442 (3d Cir. 1999) (rejecting zero loss where defendant’s misrepresentations had “but for” causal connection to loss), *appeal after remand* 248 F.3d 228 (3d Cir. 2001); *United States v. Green*, 114 F.3d 613 (7th Cir. 1997) (charging nurse who created false bills as part of insurance fraud scheme with entire loss, including payments for pain and suffering, because insurance settlements are customarily based on size of medical bills); *United States v. Copus*, 110 F.3d 1529 (10th Cir. 1997) (finding in loan fraud case that pecuniary harm attributable to false statement constituted loss); *United States v. Cheng*, 96 F.3d 654 (2d Cir. 1996) (wholesaler who accepted food stamps from restaurants caused loss); *United States v. Kopp*, 951 F.2d 521 (3d Cir. 1991) (suggesting proximate cause analysis); *United States v. Krenning*, 93 F.3d 1257 (5th Cir. 1996) (finding district court’s method of valuing loss bore no reasonable relation to harm from fraud).

package.<sup>217</sup> However, none of the theoretically available alternative standards withstood careful scrutiny.<sup>218</sup> On the one hand, a pure “but for” causation standard would be too inclusive. Chains of cause and effect run on infinitely through time. To hold a defendant criminally responsible for every adverse pecuniary consequence of his wrongdoing, no matter how remote or unforeseeable, plainly would be unfair to the defendant.

Conversely, limiting “loss” to intended economic harms—those the defendant consciously desired—would be too restrictive a measurement of offense seriousness. If a corporate treasurer embezzles company funds to speculate in futures trading or to place bets at the dog track, he may not “intend” to deprive the company of the money. He may honestly “intend” to make good his defalcations, with interest, but when the orange crop freezes or the dogs don’t run, his good intentions do not reduce the company’s financial loss and should not reduce the defendant’s sentence. When the owner of a business starts kiting checks to tide over cash flow problems, he may hope that his business will turn a corner and all the checks can be made good. But when the corner is not turned and the kite collapses leaving banks holding hundreds of thousands of dollars of worthless paper, the economic harm to the banks is not lessened by the defendant’s unfounded optimism. When a real estate swindler lies to the bank financing a development, to his partners, to purchasers of the lots, and to contractors working on the project, he may intend to steal for himself only a small fraction of the money and resources invested in the project. But the entirely predictable result of his crimes may be the collapse of the entire undertaking and financial harm to the bank, his partners, the purchasers, and the contractors far in excess of the personal gain on which the swindler’s attention was focused. In short, limiting actual loss to the amount subjectively intended by the defendant does not accurately measure the economic harm caused by the defendant’s crimes, and it permits the defendant to limit his sentencing exposure by making difficult-to-disprove claims about his benevolent intentions or about his failure to consider the likely consequences of his crime.

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217. This line of thinking would seem to have been the impetus behind one of the options in the Commission staff proposal published in January 2001, as well as in the loss definition in the March 2001 staff draft. In January 2001, the staff offered as Section 2(A) [Option 2] the option of defining “actual loss” as “the pecuniary harm that resulted or will result from the conduct for which the defendant is accountable under § 1B1.3 (Relevant Conduct).” See January 2001 Commission Draft, *supra* note 177, at 7995. The commentary accompanying Option 2 of the January 2001 staff draft stated that the purpose of this option would be to “make clear ‘but for’ causation is required but without concept of reasonable foreseeability.” *Id.* at 7993. The March 2001 staff draft would have defined “actual loss” to mean: “. . . monetary loss and property damage that resulted from the offense . . . [not including] consequential damages.” See *Final Redefinition*, *supra* note 166, at 51.

218. For an excellent summary of the debate over competing standards of causation for loss, see the statement of John D. Cline, facilitator of one of the break-out groups at the October 2000 Sentencing Commission Economic Crime Symposium, 2000 Symposium Transcript, *supra* note 176, at 33-34 (summarizing the discussion in his break-out group over possible causation standards for loss and reporting the consensus that the best standard was reasonable foreseeability).



It became clear that a proper causation standard for loss would lie somewhere between the purely objective standard of “but for” causation and a purely subjective inquiry into the defendant’s intentions. The loss definition in the 2001 economic crime package fits this bill. It insists, as a minimum, that the defendant’s offense have been a cause-in-fact of the economic harm at issue. However, it limits the defendant’s sentencing liability to those losses foreseeable to a reasonable person.

*c. The criminal law traditionally imposes punishments for reasonably foreseeable harms caused by a defendant’s criminal conduct.*—From time to time, it was suggested that holding defendants criminally responsible for reasonably foreseeable harms caused by their illegal conduct was a radical innovation. Of course, exactly the reverse is true. The concept of foreseeability has long been a staple of analysis both in determining guilt and in imposing sentences.<sup>219</sup> Foreseeability is expressly an element of crimes where the prohibited mental state is criminal negligence<sup>220</sup> and even the most aggravated degrees of recklessness.<sup>221</sup> It is also integral to determinations of guilt for crimes in which the ostensible *mens rea* involves intentionality or knowledge.<sup>222</sup> For example, a party to a conspiracy is responsible for any crime committed by a co-conspirator if it is within the scope of the conspiracy, or is a foreseeable consequence of the unlawful agreement.<sup>223</sup> In cases of accomplice liability, an accomplice “is guilty not only of the offense he intended to facilitate or encourage, but also of any reasonably foreseeable offense committed by the person he aids and abets.”<sup>224</sup> The felony murder rule, which imposes the highest

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219. “The notion of causation runs throughout the law—including the criminal law—and it is generally understood to encompass two concepts. A defendant’s conduct must generally be both the ‘cause in fact’ and the ‘proximate cause’ of some harm before liability is imposed.” *United States v. Neadle*, 72 F.3d 1104, 1119 (3d Cir. 1995) (Becker, J., concurring and dissenting).

220. *See, e.g.*, MODEL PENAL CODE § 2.02(2)(d) (1985) (defining criminal negligence to require that defendant should have been aware of a substantial and unjustifiable risk of harm).

221. *See, e.g.*, *Henderson v. Kibbe*, 431 U.S. 145, 156-57 (1977) (finding foreseeability of death a necessary component of depraved indifference murder under New York law); *Regina v. Cunningham*, 2 Q.B. 396 (Crim. App. 1957) (holding that “malice” under the Offenses against the Person Act, 1861, embraces both intentional and reckless conduct and recklessness requires evidence that defendant foresaw the threatened injury).

222. *See, e.g.*, *People v. Rakusz*, 484 N.Y.S.2d 784, 786 (N.Y. Crim. Ct. 1985) (finding defendant guilty of assault, defined as: “[w]ith intent to prevent . . . a police officer . . . from performing a lawful duty, he causes physical injury to [the officer],” when an officer frisked a struggling defendant and cut his hand on the knife, because the injury was foreseeable to defendant); *State v. Williquette*, 385 N.W.2d 145, 147, 150 (Wisc. 1986) (holding that a defendant “subjects a child” to abuse if, by act or omission, “she causes the child to come within the influence of a foreseeable risk of cruel maltreatment”).

223. *Pinkerton v. United States*, 328 U.S. 640, 647-48 (1946). *See also* *United States v. Laurenzana*, 113 F.3d 689, 693-99 (7th Cir. 1997) (defendant guilty of conspiracy to commit mail fraud where he enters scheme in which it is reasonably foreseeable that mails will be used).

224. *People v. Croy*, 710 P.2d 392, 398 n.5 (Cal. 1985) (citing *People v. Beeman*, 674 P.2d

available degree of criminal homicide for killings occurring during the commission of certain dangerous felonies, in effect substitutes foreseeability of death for the intent to cause it.<sup>225</sup>

Foreseeability of harm is also widely employed as a determinant of the harms to be considered in sentencing. Even before the 2001 economic crime sentencing reforms, the Guidelines themselves repeatedly used foreseeability as the dividing line between those harms which count for measuring offense seriousness and those which do not.<sup>226</sup> Inclusion of reasonably foreseeable harms in the criminal sentencing calculus has received the imprimatur of the United States Supreme Court, even in the capital sentencing context.<sup>227</sup>

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1318, 1326 (Cal. 1984)). See generally DRESSLER, *supra* note 40, § 30.05[B][5].

225. Some jurisdictions apply the felony murder rule to all deaths caused in fact by the commission of designated dangerous felonies, on the theory that such felonies always present a particular risk of death. LAFAVE & SCOTT, *supra* note 34, § 7.5(b), at 624-25. Other jurisdictions impose a specific requirement that the death in the particular case have been a foreseeable outcome of defendant's felony. *Id.* § 7.5(d), at 626-27.

226. See, e.g., U.S.S.G. § 1B1.3(a)(1)(B) (2000) (dictating that sentencing be based on harms resulting from the foreseeable conduct of defendant's criminal partners); *id.* § 2F1.1, app. n.8(c) (including in "loss" foreseeable consequential damages in procurement fraud and product substitution cases); see also *id.* § 2F1.1, app. n.1(a) (authorizing a departure for "reasonably foreseeable, substantial non-monetary harm"); *id.* § 2F1.1, app. n.10(c) (authorizing departure for "reasonably foreseeable" physical, psychological, or emotional harm); *United States v. Sarno*, 73 F.3d 1470, 1500-01 (9th Cir. 1995) (finding all losses on fraudulently procured loan attributable to the defendant even where the default was not his fault because it was reasonably foreseeable from the defendant's conduct that the loan would be approved, hence putting the bank's money at risk.)

227. In *Payne v. Tennessee*, 501 U.S. 808, 818 (1991), the Court approved the use of victim impact evidence over the objection that such evidence concerns "factors about which the defendant was unaware, and that were irrelevant to the decision to kill," and thus had nothing to do with the "blameworthiness of a particular defendant." (quoting *Booth v. Maryland*, 482 U.S. 496, 504, 505 (1987)). Justice Souter, in his concurrence, responded to this line of argument by observing that the harms to the surviving victims of homicide (the families, friends, communities, and loved ones of the deceased) portrayed in victim impact evidence are morally, and therefore legally, relevant precisely because they are so plainly foreseeable. Said Justice Souter:

*Murder has foreseeable consequences.* . . . Every defendant knows, if endowed with the mental competence for criminal responsibility, that the life he will take by his homicidal behavior is that of a unique person, like himself, and that the person to be killed probably has close associates, "survivors," who will suffer harms and deprivations from the victim's death . . . . *The foreseeability of the killing's consequences imbues them with direct moral relevance,* . . . and evidence of the specific harm caused when a homicidal risk is realized is nothing more than evidence of the risk that the defendant originally chose to run despite the kinds of consequences that were obviously foreseeable.

*Id.* at 838-39 (Souter, J., concurring) (emphasis added).

In dissent, Justice Stevens tacitly conceded that impact on surviving victims would be relevant if foreseeable. His argument was simply that the majority's holding



A persistent, and in my view ultimately persuasive, argument in favor of employing notions of causation and reasonable foreseeability to define loss was that these concepts were familiar tools to judges and lawyers faced with the task of determining the proper reach of responsibility for the harms caused by legally culpable conduct.<sup>228</sup>

*d. A reasonable foreseeability standard requires an assessment of the defendant's blameworthiness by requiring a nexus between the defendant's state of mind and harms counted as loss.*—As noted above, a number of the participants in the loss debate expressed concern that heavy reliance on a quantitative measure of loss to determine offense seriousness overemphasized harm as compared to considerations of mental state and other indicators of blameworthiness.<sup>229</sup> In my view, this criticism was somewhat misconceived because loss, however defined, is always a rough proxy measurement of a defendant's guilty mind, at least insofar as we can agree that a plan to steal a lot is more blameworthy than one to steal a little. Moreover, the definition of loss finally included in the 2001 economic crime package represents an improvement over the status quo precisely because it requires a judicial judgment about a defendant's fault for identified harms. It is unjust to put someone in prison for harms he neither intended nor could reasonably have anticipated would result from his choice to do wrong. It is entirely appropriate, however, to punish based on harms that would not have occurred but for the defendant's evil choices, and which the defendant either anticipated or could and should have anticipated. The new reasonable foreseeability standard obliges the sentencing court to consider the facts of the case from the perspective of a reasonable person in defendant's situation when it separates harms for which a defendant ought justly to be punished from those for which he should not.

### *B. The Details of the New Definition of Actual Loss*

The new consolidated economic crime guideline defines "actual loss" to mean "the reasonably foreseeable pecuniary harm that resulted from the

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permits a jury to sentence a defendant to death because of harm to the victim and his family that the defendant *could not foresee*, which was not even identified until after the crime had been committed, and which may be deemed by the jury, without any rational explanation, to justify a death sentence in one case but not in another.

*Id.* at 863 (Stevens, J., dissenting) (emphasis added).

228. The familiarity of these concepts was a theme sounded from the outset of the economic crime sentencing debate. See Bowman, *Coping with "Loss,"* *supra* note 103, at 536; Bowman, *Back to Basics,* *supra* note 155, at 119.

229. See *supra* Part IV.A.2.b; see also 1997 *Hearing Excerpts*, *supra* note 106, at 162 (colloquy of Commissioner Deannell Tacha and Professor Frank Bowman); *id.* at 164 (testimony of Professor Frank Bowman); Newman, *supra* note 122, *passim*; and the comments of Judge Jon O. Newman, Senior Judge, United States Court of Appeals for the Second Circuit, and others, at the Second Plenary Session of the Third Symposium on Crime and Punishment in the United States, Oct. 12, 2000, available at <http://www.ussc.gov/AGENDAS/symposium.htm>.

offense.”<sup>230</sup> The key term “reasonably foreseeable pecuniary harm” means “pecuniary harm that the defendant knew or, under the circumstances, reasonably should have known, was a potential result of the offense.”<sup>231</sup> In combination, these two provisions should prove to be a sound, workable core definition of actual loss. Several fine points deserve additional analysis.

1. *The Limitation to Harm That “Resulted from” the Offense.*—

a. *“But for” causation.*—As noted above, the concept of causation in the law has two elements, cause-in-fact and legal cause.<sup>232</sup> In the new loss definition, reasonable foreseeability is the standard for legal cause. The phrase “resulted from” addresses cause in fact. In its statement of reasons accompanying the economic crime package, the Commission makes clear that a loss that “resulted from” an offense is one that would not have occurred “but for” the occurrence of the offense.<sup>233</sup>

b. *Temporal limitations on includable losses.*—Notice that the phrase “resulted from the offense” is expressed in the past tense. This choice of words implies that, in order to be counted in loss, pecuniary harms must already have manifested themselves in some way at the time loss is calculated. The issue of time-of-measurement of loss is addressed in detail below in Part IV.E.

2. *The Meaning of “the Offense.”*—Nearly all of the debate over loss focused on the concept of harm and the proper definition of the causal link between culpable conduct and includable harm. Much less discussed was the question of what conduct should count as the starting point of the chain of cause and effect leading to includable harm. All the early drafts of the loss definition contained language specifying that loss was harm resulting from conduct for which the defendant was accountable under the relevant conduct guideline, Section 1B1.3.<sup>234</sup> The January 2001 CLC draft also included this specification. The last two Commission staff drafts—the January 2001 draft published in the

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230. U.S.S.G. § 2B1.1, app. n.2(A)(i). (2001).

231. *Id.* § 2B1.1, app. n.2(A)(iv).

232. *See supra* notes 210-12 and accompanying text.

233. *See* Statement of Reasons, *supra* note 117, at 30543 (“The amendment incorporates this causation standard that, at a minimum, requires factual causation (often called “but for” causation) and provides a rule for legal causation (i.e., guidance to courts regarding how to draw the line as to what losses should be included and excluded from the loss determination).”).

234. *See* Bowman, *Coping with “Loss,” supra* note 103, at 572 (proposing loss definition limited to harm “caused by the acts and omissions specified in subsections (a)(1) and (a)(2) of § 1B1.3 (Relevant Conduct)”; *Final Redefinition, supra* note 166, at 43 (Draft Loss Redefinition by USSC Staff, Feb. 20, 1998, limiting loss to harm resulting “from the conduct for which the defendant is accountable under § 1B1.3 (Relevant Conduct)”; *id.* at 45 (Proposed Loss Definition, Apr. 2, 1998 version, limiting loss to harm resulting “from the conduct for which the defendant is accountable under § 1B1.3 (Relevant Conduct)”; *id.* at 47 (Proposed Loss Definition, May 1999 Staff Draft, limiting loss to harm resulting “from the conduct for which the defendant is accountable under § 1B1.3 (Relevant Conduct)”; *id.* at 49 (CLC Proposed Definition of Loss, Jan. 2001, limiting loss to harm resulting “from the conduct for which the defendant is accountable under § 1B1.3 (Relevant Conduct)”).



Federal Register<sup>235</sup> and the March 2001 staff draft<sup>236</sup>—omitted the reference to the relevant conduct guideline, referring instead simply to “the offense.” This same usage was adopted in the final loss definition.<sup>237</sup> The Commission’s statement of reasons does not explain this particular drafting choice. Nonetheless, there is no cause to think it has substantive significance. Rather, the drafters felt that the cross-reference to Section 1B1.3 was unnecessary because the relevant conduct rules apply to all offense types.

3. *The Limitation to Pecuniary Harm.*—The injuries to victims of theft, fraud, and other “economic” crimes are not necessarily limited to economic harm. Victims may suffer emotional harm, damage to reputation, disruption of personal or business relationships, or even physical illness. Because harms of this sort are often foreseeable to defendants, one might, as the economists say, “monetize” non-economic harms by assigning monetary values to injuries such as emotional distress (as courts and juries do routinely in civil lawsuits) and include the monetary value of foreseeable non-economic harms in loss. However, there was never any support for including non-economic harms in loss. Indeed, with a single exception, every draft redefinition of loss advanced during the five-year debate over the economic crime package, regardless of its authorship, contained language limiting loss to “pecuniary” or “monetary” harms.<sup>238</sup> The new definition specifically excludes non-economic harms by defining loss to include only “pecuniary harm.”<sup>239</sup> To make the point still clearer, the new guideline commentary defines “pecuniary harm” as “harm that is monetary or that is otherwise readily measurable in money. Accordingly, pecuniary harm does not include emotional distress, harm to reputation, or other non-economic harm.”<sup>240</sup>

There will doubtless be cases in which courts will need to explore the

235. See January 2001 Commission Draft, *supra* note 177 (limiting loss to harms resulting from “the offense”).

236. See *Final Redefinition*, *supra* note 166, at 51 (Proposed Redefinition of “Loss”: Mar. 2001 Sentencing Commission Staff Draft, limiting loss to harms resulting from “the offense”).

237. U.S.S.G. § 2B1.1, app. n.2(A)(i) (2001).

238. E.g., Bowman, *Coping with “Loss,” supra* note 103, at 572 (proposing loss definition limited to “pecuniary harm” and stating that “[T]he phrase ‘pecuniary harm’ is to be given its common meaning. Many physical and emotional harms, injuries to reputation, etc. can be assigned a monetary value. However, ‘loss’ does not measure harms of this kind. Its purpose is to measure economic harms.”); *Final Redefinition*, *supra* note 166, at 45 (Proposed Loss Definition, Apr. 2, 1998 version, limiting loss to “pecuniary harm”); *id.* at 47 (Proposed Loss Definition, May 1999 Staff Draft, limiting loss to “pecuniary harm”); *id.* at 49 (CLC Proposed Definition of Loss, Jan. 2001, limiting loss to “pecuniary harm”); *id.* at 51 (Proposed Redefinition of “Loss”: Mar. 2001 Sentencing Commission Staff Draft limiting actual loss to “monetary loss and property damage”). The only proposed redefinition that did not limit loss to pecuniary or monetary harms was the very first Commission staff proposal in February 1998, *id.* at 43 (Draft Loss Redefinition by United States Sentencing Commission Staff, Feb. 20, 1998).

239. U.S.S.G. § 2B1.1, app. n.2(A)(i) (2001).

240. *Id.* § 2B1.1, app. n.2(A)(iii).

boundaries of the pecuniary harm category. In such cases, courts should be mindful that a consistent theme throughout the long economic crime package debate was the concern that defining loss in terms of reasonable foreseeability would transform federal theft and fraud sentencings into civil damage award hearings, with judges obliged to assign monetary values to intangible harms. The limitation of loss to pecuniary harm, those harms “readily measurable in money,”<sup>241</sup> was specifically intended to forestall such wide-ranging inquiries.

4. *Product Substitution, Procurement Fraud, and Protected Computer Cases—Specific Examples of Reasonably Foreseeable Pecuniary Harms or Special Cases?*—As noted above, the former theft and fraud guidelines contained a number of opaque and convoluted provisions relating to causation.<sup>242</sup> Among these was the limitation of fraud loss to “direct damages,” except in cases of procurement fraud and product substitution, where “consequential damages” were to be included in loss if “reasonably foreseeable.”<sup>243</sup> The former fraud guideline went on to specify the types of victim costs that should be included in loss in product substitution and procurement fraud cases:

[I]n a case involving a defense produce substitution offense, the loss includes the government’s reasonably foreseeable costs of making substitute transactions and handling or disposing of the product delivered or retrofitting the product so it can be used for intended purpose, plus the government’s reasonably foreseeable cost of rectifying the actual or potential disruption to government operations caused by the product substitution. Similarly, in the case of fraud affecting a defense contract award, loss includes the reasonably foreseeable administrative cost to the government and other participants of repeating or correcting the procurement action affected, plus any increased cost to procure the product or service involved that was reasonably foreseeable.<sup>244</sup>

In light of the fact that the new economic crime guideline defines loss to include reasonably foreseeable harms for all theft and fraud cases, special provisions for procurement fraud and product substitution cases might have been discarded as superfluous. Alternatively, these provisions might have been retained as examples of the reasonably foreseeable pecuniary harms now to be included in loss.<sup>245</sup> Somewhat oddly, the Commission chose instead to transfer the precise language of the former fraud guideline regarding loss in procurement fraud and product substitution cases to the new loss definition under the subheading “Rules of Construction in Certain Cases.”<sup>246</sup>

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241. *Id.*

242. *See supra* notes 127-35 and accompanying text.

243. U.S.S.G. § 2F1.1, app. n.8(c) (2000).

244. *Id.*

245. For example, this was the approach taken by the judges of the CLC in their proposed loss definition. *See Final Redefinition, supra* note 166, at 49-51 (CLC Proposed Definition of Loss, Jan. 2001).

246. U.S.S.G. § 2B1.1, app. n.2(A)(v)(I)-(II) (2001).



The retention of special procurement fraud and product substitution provisions is easily explained from a political perspective. The Department of Justice insisted on keeping the old language to insure that loss in these cases would be no less expansive under the new definition than it had been before. However, the way in which the old language was placed in the new guideline gives rise to some potential interpretive difficulties. It is unclear whether sentencing courts should view the procurement fraud and product substitution subsections only as specific directives in those particular types of cases or also as examples of the reach of reasonable foreseeability in other types of cases. The legislative history of the economic crime package tends to support the view that the procurement fraud and product substitution provisions should be considered examples and analogies as well as case-type-specific directives. However, the third provision on the list of “Rules of Construction in Certain Cases” places at least a shadow of doubt on this construction.

The commentary to the former theft guideline provided that loss in an offense involving a “protected computer”<sup>247</sup> “includes the reasonable cost to the victim of conducting a damage assessment, restoring the system and data to their condition prior to the offense, and any lost revenue due to interruption of service.”<sup>248</sup> Notice that this language refers to the reasonableness of the victim’s costs, but includes no restriction on the foreseeability of such costs to the defendant. Again in response to Justice Department concerns, the Commission preserved the special “protected computer” section by inserting it into the new loss definition, as the third item on the list “Rules of Construction in Certain Cases.”<sup>249</sup> Moreover, the Commission revised the old “protected computer” language before inserting it into the new economic crime guideline. The new version states that, in protected computer cases, the pecuniary harms listed in the former guideline are now to be included in loss “regardless of whether such pecuniary harm was reasonably foreseeable.”<sup>250</sup> This added language places computer cases completely outside the loss paradigm governing all other theft, fraud, and destruction of property cases.<sup>251</sup> It would also permit an argument that, in common with the protected computer subsection, the procurement fraud and product substitution subsections are intended to be read as *sui generis*, and not as examples of reasonably foreseeable harms includable in loss in other types of case.

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247. The term “protected computer” is defined in 18 U.S.C. § 1030(e)(2)(A)-(B) (1994).

248. U.S.S.G. § 2B1.1, app. n.2 (2000).

249. *Id.* § 2B1.1, app. n.2(A)(v)(III) (2001).

250. *Id.*

251. This last-minute addition to the computer crime provision of the loss definition seems to have slipped under the radar. It was not the subject of any public briefing, debate, or discussion of which I am aware. Candidly, it seems a bad idea, both unjustifiable as a matter of sentencing theory and unnecessary in practice.

*C. Pecuniary Harms Excluded from Actual Loss*

The new loss definition excludes from loss interest and most investigative costs. Although such pecuniary harms will often be foreseeable to defendants, the Sentencing Commission decided that their inclusion in loss would do little if anything to advance the purposes of sentencing.

1. *The Exclusion from Loss of Foreseeable Investigative Costs of the Government, and Costs Incurred by Victims in Aiding the Government.*—One of the foreseeable consequences of crime is that the government will investigate and prosecute those offenses of which it becomes aware. It is also foreseeable that victims of crime will assist the investigation. Criminal investigations and prosecutions cost money. Thus, one might include in “loss” the foreseeable costs of investigating and prosecuting the defendant’s crimes. However, there was universal agreement that such costs should not affect sentence length.<sup>252</sup> First, the amount of money the government spends to investigate and prosecute a case often depends on fortuitous factors unrelated to the seriousness of the offense or the defendant’s overall blameworthiness—considerations such as the thoroughness of the investigators, the number and location of witnesses, whether expert witnesses or specialized forensic techniques are required, and so forth. Second, even if investigative costs could be shown to bear some rough relationship to offense seriousness or defendant culpability, the investment of judicial time and resources necessary to accurately determine investigative costs would be unlikely to produce commensurate gains in the accuracy of the loss figure as a measurement of relative culpability between defendants. Therefore, the new economic crime guideline specifically excludes from loss “[c]osts to the government of, and costs incurred by victims primarily to aid the government in, the prosecution and criminal investigation of an offense.”<sup>253</sup>

The only point of contention that might arise under this provision is that its language seems to permit a court to include in loss the investigative costs of both victims and government agencies in connection with civil proceedings. For example, the government might argue that investigative costs it incurred pursuing

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252. No participant in the loss debate ever suggested including investigative costs in loss. Most of the draft redefinitions of loss included language excluding investigative costs. The first proposal to exclude such costs referred only to “costs incurred by government agencies in criminal investigation or prosecution of the defendant.” Bowman, *Coping with “Loss,” supra* note 103, at 573. The first Commission draft to exclude investigative costs was the April 2, 1998 version, which excluded government investigative costs in a background note. *Final Redefinition, supra* note 166, at 47 (Proposed Loss Definition, Apr. 2, 1998 Version). By May 1999, Commission staff had expanded the exclusion to embrace “costs incurred by victims primarily to aid the government in, the prosecution and criminal investigation of an offense.” *Id.* at 47 (Proposed Loss Definition, May 1999 Staff Draft). This formulation, excluding both government and some private investigative costs, carried through all subsequent drafts into the final version of the economic crime package. *Id.* at 49 (CLC Proposed Definition of Loss, Jan. 2001); *id.* at 52 (Proposed Redefinition of “Loss”: Mar. 2001 Sentencing Commission Staff Draft).

253. U.S.S.G. § 2B1.1 n.2(D)(ii) (2001).



administrative remedies or civil forfeiture against the defendant arising out of the offense conduct could be included in loss. Likewise, the prosecution might assert that legal fees and other costs incurred by victims in private civil actions against the defendant arising from the offense conduct should also count as loss. How such arguments will be received by sentencing courts remains to be seen.<sup>254</sup>

2. *The Exclusion from Loss of Interest.*—The former theft and fraud guidelines excluded interest from loss. Application Note 8 to former Section 2F1.1 said that loss “does not . . . include interest the victim could have earned on such funds had the offense not occurred.”<sup>255</sup> Nonetheless, interest proved a difficult issue in the debate over redefining loss because for some years a number of courts of appeals had (depending on one’s point of view) either simply ignored the former Guidelines or interpreted them creatively in order to include “bargained-for” interest in loss.<sup>256</sup> The Commission considered two basic approaches to interest: exclude all interest, including both bargained-for and so-called “opportunity cost” interest, or include interest only in cases in which the promise of a return on investment was part of the inducement to fraud (“bargained-for” interest).<sup>257</sup> After considering the arguments outlined below, the

254. My own sense, drawn from the fairly limited discussions of this particular question during the loss debates, is that the Commission adopted this language contemplating that certain costs incurred by victims to discover the existence of a crime or to remedy its financial effects would be included in loss. The boundaries of this category of includable loss were never discussed in any detail.

255. U.S.S.G. § 2F1.1, app. n.8 (2000).

256. *See* *United States v. Sharma*, 190 F.3d 220, 228 (3d Cir. 1999) (distinguishing “opportunity cost interest” from “bargained-for interest” and including the latter in loss); *United States v. Nolan*, 136 F.3d 265, 273 (2d Cir. 1998) (unpaid interest and penalty fees included in loss); *United States v. Gilberg*, 75 F.3d 15, 19 (1st Cir. 1996) (including \$726,637 in accrued mortgage loan interest); *United States v. Goodchild*, 25 F.3d 55, 65 (1st Cir. 1994) (including finance charges and late fees in loss from unauthorized credit card use); *United States v. Henderson*, 19 F.3d 917, 928 (5th Cir. 1994) (“Interest should be included if . . . the victim had a reasonable expectation of receiving interest from the transaction.”); *United States v. Jones*, 933 F.2d 353, 354–55 (6th Cir. 1991) (finding interest should be included where defrauded credit card companies had reasonable expectation of specific return on credit extended); *cf.* *United States v. Guthrie*, 144 F.3d 1006, 1011 (6th Cir. 1998) (holding inclusion of interest lost by creditors of defendant in bankruptcy fraud scheme was erroneous); *United States v. Clemmons*, 48 F.3d 1020, 1025 (7th Cir. 1995) (finding loss includes bargained-for interest), *overruled by* *United States v. Allender*, 62 F.3d 909, 917 (7th Cir. 1995); *United States v. Moored*, 38 F.3d 1419, 1423–24 (6th Cir. 1994) (stating in dictum that loss does not include interest); *United States v. Lowder*, 5 F.3d 467, 471 (10th Cir. 1993) (holding interest should be included where defendant promised victims a specific interest rate).

The Fourth Circuit excluded interest categorically. *See United States v. Hoyle*, 33 F.3d 415, 419 (4th Cir. 1994); *see also United States v. Allen*, 88 F.3d 765, 771 (9th Cir. 1996).

257. The April 2, 1998 Commission draft includes as Option 1 the exclusion of all interest and similar costs, and as Option 2 the exclusion of all interest except that “bargained for as part of a lending transaction that is involved in the offense.” *Final Redefinition*, *supra* note 166, at 45

Commission decided on a categorical exclusion of interest of all types from loss. The new economic crime guideline states: "Loss shall not include . . . [i]nterest of any kind, finance charges, late fees, penalties, amounts based on an agreed-upon return or rate of return, or other similar costs."<sup>258</sup>

*a. An analysis of the arguments for inclusion of interest.*—Consistency with the core definition of loss suggests inclusion of interest. If a criminal steals money that the victim would otherwise have loaned to or invested with an honest person or institution, it is reasonably foreseeable that the victim will lose not only his principal, but also the time value of that money. Loss of the time value of money is, from an economic point of view, indisputably a "harm" suffered by the victim of a fraud. But the consistency argument proves too much. If "loss" is to include the time value of stolen money, then consistency dictates that time value should be included not only when the defendant defrauds a victim by promising payment of "interest," but also when he promises a return on investment in the form of "dividends," "capital gains," or "profits." A defendant's sentence should not turn on the fortuity of the name used to characterize the promised return on investment. Likewise, a victim suffers the harm of lost time value of his money even if the scheme is one that involves no promise of return on investment. For example, an insurance company defrauded by an insured who torches his own business and then collects fire insurance proceeds is deprived of the time value of the insurance payout no less than it would be if the company had lost the same amount by investing it with a crooked stock broker who falsely promised a high rate of return.

*b. "Bargained-for" interest.*—The approach of those courts which sought to evade the former prohibition against interest by including interest specifically promised by a defendant as part of the inducement to the victim to part with his money gave rise to strong theoretical and practical objections.

First, "loss" is primarily a measurement of harm actually suffered by the victim, not of the magnitude of the false promises of the crooked defendant. If a defendant defrauded Victim A by promising payment of ten percent interest monthly, A's "actual loss" is not his principal plus 120% annual interest *because there was never a realistic possibility that the defendant or anyone else would pay him interest at that rate.* The only reliable measure of what the victim lost by giving his money to the defendant rather than investing it with an honest person is the market rate for invested money. (And even this is highly speculative because there is no way of knowing whether the victim would indeed have invested it.)

Second, using the interest rate promised by defendants creates a disparity of punishment between similarly situated defendants. Three defendants who stole the same amount of money should not receive different sentences merely because the first falsely promised his victims a fifty percent return, the second promised 100%, and the third committed a form of fraud (like the arsonist who defrauded his fire insurer in the example above) that involved no promise of return on

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(Proposed Loss Definition, Apr. 2, 1998 Version).

258. U.S.S.G. § 2B1.1, app. n.2(D)(i) (2001).



investment. Likewise, two defendants who stole the same amount of money by falsely promising a twenty-five percent return on investment should not receive different punishments because the first characterized the promised payment as “interest,” while the second happened to call the promised payment “dividends.”

Third, using different interest rates in every case adds to sentencing complexity. There will be inevitable disputes over exactly what rate of return was promised. Particularly in multi-victim fraud cases, it will often prove that the defendant promised different rates of return to different victims. In such cases, the court would not only have to make findings about exactly what was promised each of perhaps dozens or hundreds of victims, but then someone would have to do the resulting math to arrive at a loss number.

Courts may have been drawn into including bargained-for interest by two unarticulated lines of thought. The first is an unconscious reversion to memories of first-year contracts and the recollection that aggrieved contract litigants are often entitled to the “benefit of the bargain” as a measure of damages.<sup>259</sup> But calculation of loss in a criminal sentencing is not a contracts problem. In contracts, courts are concerned, not with punishment of the morally blameworthy, but with enforcement of (primarily commercial) agreements.<sup>260</sup> The benefit of the bargain rule, when it is applicable, focuses on ensuring that the non-breaching party is disadvantaged as little as possible by the breach of the agreement, not on measuring moral culpability of the party in breach. Moreover, even in contracts, the prevailing litigant is only sometimes entitled to the benefit of his bargain; other measures of damages are as or more common.<sup>261</sup>

The second idea that may lie behind the “bargained for” interest cases is the notion that the magnitude of the defendant’s false promises is somehow a proxy measurement for the defendant’s blameworthiness. This, however, is a false equivalency. A crook who euchres a victim out of \$1000 by falsely promising a ten percent monthly return is by no rational calculation either more or less blameworthy than another crook who inveigles the victim into parting with the same \$1000 with a false promise of a fifteen percent monthly return. The harm to the victim in both cases is the same, and the true measure of each defendant’s blameworthiness is his settled desire to cheat the victim of \$1000, rather than the

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259. See, e.g., JOHN EDWARD MURRAY, JR., MURRAY ON CONTRACTS § 219, at 438 (1974). Murray posits that

The purpose of contract law is often stated as the fulfillment of those expectations which have been induced by the making of a promise. If the promise is breached the legal system protects the expectations by attempting to place the injured promisee in the position he would have been in had the promise been performed.

*Id.*

260. “The law of contracts is concerned with the securing and protection of those economic interests which result from assurances.” *Id.* § 1, at 2.

261. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 344, app. a (1979) (emphasizing that securing to a non-breaching promisee the benefit of his bargain is only one of three interests served by the law of remedies for breach of contract, the other two being reliance and restitution, and that the relief granted “may not correspond precisely to any of these interests”).

particular false promises he makes in his efforts to do so. In short, among the competing proposals regarding interest, the “bargained for” interest option was the least desirable of the lot.

c. *Additional arguments for total exclusion of interest.*—Including interest introduces all the problems of equity between defendants and complexity of calculation just discussed, but does little to make loss a more accurate measure of relative offense seriousness. Indeed, even when interest is assessed at differing rates for different defendants,<sup>262</sup> the interest component of loss is in some significant degree a proxy measurement, not of relative offense seriousness, but of the length of time elapsed between the taking of the money and the date that loss is measured preparatory to sentencing. For example, assume two defendants each steal \$10,000 by the same means on the same date, but one is sentenced six months and the other eighteen months after the crime. If loss is measured as of the date of the sentencing, the defendant sentenced later would have more interest added to his loss figure and therefore, at least potentially, would receive a longer sentence. This is an absurd and unjust result. Even if loss is to be measured at the time of detection,<sup>263</sup> then accrued interest becomes a proxy measurement for the length of time the defendant evaded detection. This may arguably bear some attenuated relationship to culpability, but it is a long stretch.

d. *The Commission’s decision to exclude interest.*—The Commission seems to have been convinced that courts should not expend valuable resources on quantifying interest as an element of loss when the result of the labor advances the purposes of sentencing so little. In its statement of reasons, the Commission wrote that, “This rule [that interest should be excluded from loss altogether] is consistent with the general purpose of the loss determination to serve as a rough measurement of the seriousness of the offense and culpability of the offender and avoids unnecessary litigation regarding the amount of interest to be included.”<sup>264</sup>

e. *The upward departure for interest.*—Despite the blanket exclusion of interest and related costs from loss itself, the Commission nonetheless adopted a provision listing interest as a factor that might support an upward departure. An upward departure may be warranted if “[t]he offense involved a substantial

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262. Had the Commission decided to include in “loss” interest of any type, I would have recommended that the guidelines adopt a standard interest rate for all defendants. This would ameliorate some of the problems identified above. It would accurately measure the true economic worth of the harm suffered by victims fraudulently deprived of the time value of their money, and it would eliminate the inequities created by calculating the sentences of defendants who stole identical amounts based on the fortuity of the particular false promises they made. Federal law establishes a rate to be paid to litigants in civil cases in 28 U.S.C. § 1961 (1994). If interest in any form were to be added into “loss,” the simplest, most equitable, and most theoretically sound way of doing so would be to use a standard statutory rate. For further discussion on this point, see Bowman, *Coping with “Loss,”* *supra* note 103, at 540-41.

263. See *infra* Part IV.E (discussing time-of-measurement provisions of the new economic crime guideline).

264. Statement of Reasons, *supra* note 117, at 30543.



amount of interest of any kind, finance charges, late fees, penalties, amounts based on an agreed-upon return or rate of return, or other similar costs, not included in the determination of loss for purposes of subsection (b)(1).”<sup>265</sup> Considered strictly on the merits, this provision seems difficult to justify. The point of excluding interest is that including it produces difficulties in calculation, invites disparate sentences, and is unlikely to make the resulting loss figure any more accurate a measure of relative culpability. A categorical exclusion produces substantial gains in simplicity and clarity. Circuit courts have already proved remarkably adept at slipping interest into loss, even in the face of the existing prohibition against it.<sup>266</sup> Leaving the back door ajar by putting in a departure provision would seem to risk more of the same. Moreover, with no guidance as to what a “substantial” amount of interest might entail, the language seems likely to prove difficult to interpret, and pregnant with the possibility of unjustifiable disparity between similarly situated defendants.<sup>267</sup> At all events the Commission contemplates that an upward departure based on a substantial amount of interest will be “rare.”<sup>268</sup>

*D. “Net” vs. “Gross” Loss: The Problem of Accounting for Things of Value Transferred to the Victim by the Defendant*

In many economic crime cases, particularly those involving fraud in some form, a defendant will transfer or return something of value to the victim as part of the scheme. Even in simple theft or embezzlement cases a defendant will sometimes return all or part of the money or property stolen before the crime is detected by either the victim or authorities. Because loss is a measurement of the economic harm suffered by the victims of a defendant’s criminal conduct, the question then arises whether loss is “net” or “gross.” That is, should the value of the money or property abstracted from the victim be offset by the value of the money or property transferred or returned to the victim by the defendant? In the debates over the economic crime package, this question was often referred to as the “crediting” problem.

1. *The Law Under the Former Theft and Fraud Guidelines.*—Crediting issues were a frequent subject of opinions construing the loss provisions of the former theft and fraud guidelines. The most commonly encountered problems were:

- (a) whether a defendant should be given credit for repayments or recoveries

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265. U.S.S.G. § 2B1.1, app. n.15(A)(iii) (2000).

266. See note 256 and accompanying text.

267. For the reasons stated in the text, the judges of the CLC opposed a departure for interest. See *CLC Comments*, *supra* note 182, at 42; Bowman, *supra* note 178, at 474. The inclusion of an interest departure was a concession to the Justice Department in the bargaining leading up to the final April 2001 vote on the economic crime package.

268. “[T]he amendment provides that a departure may be warranted in the rare case in which exclusion of interest will under-punish the offender.” Statement of Reasons, *supra* note 117, at 30543.

made after discovery of the crime, but before sentencing;

(b) whether a defendant should be given credit for amounts or assets pledged as collateral as part of a fraudulently induced transaction;

(c) whether a defendant should be given credit for repayments made after the completion of the theft or fraud, but before detection of the crime; and

(d) whether a defendant should be given credit in the calculation of actual loss for anything of value he gives to victims as part of a scheme to deprive them of money or property.

The answers to the first and second questions were clear. First, payments made by the defendant or recoveries of property occurring after discovery of the crime but before sentencing, were not credited to the defendant.<sup>269</sup> The only arguable exception to this first general rule was created by a second general rule—assets pledged by a defendant to a victim as part of a fraudulently induced transaction were credited against loss regardless of whether the victim took control of the pledged asset before or after detection of the crime.<sup>270</sup>

The more difficult questions arose in addressing the third and fourth

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269. *E.g.*, *United States v. Stoddard*, 150 F.3d 1140, 1146-47 (9th Cir. 1998) (refusing to credit post-detection repayments against loss); *United States v. Pappert*, 104 F.3d 1559, 1568 (10th Cir. 1997) (refusing to credit repayments made after detection, but before arrest); *United States v. Smith*, 62 F.3d 1073, 1079 (8th Cir. 1995) (finding credit card fraud defendant responsible for total amount of unauthorized charges and giving no credit for items obtained by fraud, but later recovered); *United States v. Akin*, 62 F.3d 700, 702 (5th Cir. 1995) (presentence restitution did not reduce loss calculation); *United States v. Graham*, 60 F.3d 463, 467-68 (8th Cir. 1995) (result of loss calculation not be reduced merely because defendant's fraudulent scheme was not entirely successful); *United States v. Asher*, 59 F.3d 622, 625 (7th Cir. 1995) (fact that check-kiting defendant immediately repaid \$160,000 overdraft outstanding at time of discovery does not affect "loss" figure); *United States v. Norris*, 50 F.3d 959, 961-62 (11th Cir. 1995) (holding that repayments on student loan came too late to reduce loss); *United States v. Mau*, 45 F.3d 212, 216-17 (7th Cir. 1995) (arranging a fully collateralized repayment plan after discovery will not reduce loss); *United States v. Bean*, 18 F.3d 1367, 1369 (7th Cir. 1994) (no departure for pre-sentence restitution); *United States v. Carey*, 895 F.2d 318, 323-24 (7th Cir. 1990) (reversing a district court's downward departure for presentencing restitution, noting that restitution may be relevant to acceptance of responsibility under Guidance Section 3E1.1, or to a departure under Section 5K2.0, if extraordinary, but that mere restitution was not enough).

270. Pursuant to Guidelines Section 2F.1.1, app. n.8(b) (2000), actual loss was "the amount of the loan not repaid at the time the offense is discovered, reduced by the amount the lending institution has recovered (or can expect to recover) from any assets pledged to secure the loan." *Id.* In general, courts construing this provision routinely deducted the value of pledged collateral from loss; however, there remained some disagreement over fine points. See ROGER W. HAINES, JR., FRANK O. BOWMAN, III, & JENNIFER C. WOLL, *FEDERAL SENTENCING GUIDELINES HANDBOOK* 485-86 (Nov. 2000 ed.) (discussing treatment of collateral in the measurement of fraud loss under the former fraud guideline); see also John D. Cline, *Calculation of Loss Under the Sentencing Guidelines*, 9 GEO. MASON L. REV. 357, 363 (2000) (stating that "several courts have stated that the actual loss is the amount of the loan not repaid at the time of sentencing, reduced by the value of any security pledged by the defendant," and collecting cases).



problems listed above—whether to credit defendants for repayments made prior to detection but after “completion” of the offense, and whether to credit defendants for things of value transferred to victims by the defendant as part of the scheme to obtain the victims’ money or property.

For example, there was general agreement that a defendant should be given credit for anything of value he transfers to a victim in return for the money or property obtained by fraud. The commentary to the former fraud guideline required that in a case of fraudulent misrepresentation of the value of goods, any loss suffered by the victim must be offset by the value of the goods delivered by the defendant.<sup>271</sup> Moreover, the courts of appeals held that in almost all economic crime cases with a flavor of fraud that the Guidelines’ insistence on a measurement of net detriment to the victim was not limited to cases involving misrepresentation of the value of goods.<sup>272</sup> On the other hand, as will be

271. U.S.S.G. § 2F.1, app. n.8(b) (2000) stated:

A fraud may involve the misrepresentation of the value of an item that does have some value (in contrast to an item that is worthless). Where, for example, a defendant fraudulently represents that stock is worth \$40,000 and the stock is worth only \$10,000, the loss is the amount by which the stock is overvalued (i.e. \$30,000). In a case involving a misrepresentation concerning the quality of a consumer product, the loss is the difference between the amount paid by the victim for the product and the amount for which the victim could resell the product received.

272. See *United States v. Barnes*, 125 F.3d 1287, 1290-91 (9th Cir. 1997) (finding that the sentencing court erred in failing to consider benefits the defendant provided a plasma center while fraudulently impersonating a doctor, and holding that “the victim has sustained no loss because he received the services for which he bargained, despite the fact that he received them from a person who was not legally authorized to offer them.”); *United States v. Sublett*, 124 F.3d 693, 695 (5th Cir. 1997) (vacating the defendant’s sentence in a contracting fraud case where the trial court failed to give the defendant credit against the loss amount for legitimate services he provided or intended to provide, and holding that, “The district court therefore must deduct the value of the legitimate services actually provided by [defendant’s] operation under the first contract and those that he intended to provide under the second contract in its calculation of the loss under section 2F1.1(b)(1).”); *United States v. Williams*, 111 F.3d 139, 1997 WL 187342 at \*4 (9th Cir. 1997) (“Consistent with our prior cases, ‘actual loss’ under the guidelines should be measured as the ‘net loss’ flowing from the defendant’s conduct.”); *United States v. Pappert*, 104 F.3d 1559, 1568 (10th Cir. 1997) (holding that the sentencing court should calculate “net loss by subtracting the value of what was given to the victim(s) during the course of the transaction from the value of what was fraudulently taken”); *United States v. Carroll*, 87 F.3d 1315, 1996 WL 266425, at \*3 (6th Cir. 1996) (unpublished disposition) (“The guidelines do require the district court to determine the net loss.”); *United States v. Kohlbach*, 38 F.3d 832, 840-42 (6th Cir. 1994) (where defendants fraudulently sold adulterated orange juice containing beet sugar instead of pure orange juice concentrate, loss calculated by subtracting wholesale price of beet sugar from price of orange concentrate, then multiplying by amount of sugar used in the adulterated juice); *United States v. Harper*, 32 F.3d 1387, 1391 (9th Cir. 1994) (holding actual loss “is a measure of what the victims of the fraud were actually relieved of,” or the net loss to the victim) (citing *United States v. Haddock*, 12 F.3d 950, 961 (10th Cir. 1993)); *United States v. Lavoie*, 19 F.3d 1102, 1105 (6th Cir.

discussed in detail below, a number of courts declined to credit defendants in "Ponzi" scheme investment frauds with pre-detection repayments to early investors.<sup>273</sup>

Similar discrepancies arose in cases that looked more like theft or embezzlement than fraud. On the one hand, the net loss rule applied to fraud cases was universal in check-kiting schemes. The courts held that the proper measurement of "loss" in a check-kiting case is the actual loss to the victim bank as reflected by the amount of the overdraft at the time the kite is detected.<sup>274</sup> On the other hand, courts took very different approaches to other closely related forms of stealing from banks. In *United States v. Johnson*,<sup>275</sup> a credit union clerk "embezzled" \$88,483.41 by transferring it to a dummy account in the credit union and then withdrawing it and "misapplied" another \$318,915 by transferring it to another account in the credit union, but not withdrawing it. She turned herself in before withdrawing the \$318,915. The Eighth Circuit held that the loss

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1994) (loss based on actual or expected loss, rather than face value of total loan proceeds); *Haddock*, 12 F.3d at 961 (holding that in determining actual loss, "only net loss is considered; anything received from the defendant in return reduces the actual loss."); *United States v. Whitlow*, 979 F.2d 1008, 1012 (5th Cir. 1992) (holding that the loss incurred by consumers to whom defendant fraudulently sold cars with altered odometers was the price paid by the victim to the defendant less the market value of the vehicles as measured by their resale value); *United States v. Sloman*, 909 F.2d 176, 182 (6th Cir. 1990) (insurer's net out-of-pocket loss due to defendant's fraudulent acts was proper basis for determining the defendant's sentence). In *United States v. Palmer*, the court upheld the district court's loss calculation against defendant's complaint that court failed to credit him "for the value of products received by the victims, refunds, bounced checks, and stop payment orders." 122 F.3d 215, 222 (5th Cir. 1997). The opinion impliedly conceded that such offsets were proper, but relied on the district court's finding that "the government, which generated the total loss figure, had done its best to exclude such items from its calculations." *Id.* See also *United States v. Peterson*, 101 F.3d 375, 383-384 (5th Cir. 1996) (agreeing with the district court that defendant in stock fraud scheme should be credited with amounts paid to investors as returns, but not with money defendant claimed an intention to repay); *United States v. Krenning*, 93 F.3d 1257, 1269 (5th Cir. 1996) ("the focus of the loss calculation should be on the harm caused to the victim of the fraud," citing with approval, *United States v. Orton*, 73 F.3d 331, 333 (11th Cir. 1996), in which the Eleventh Circuit adopted a net loss approach to determining loss in Ponzi schemes).

273. See *infra* notes 290-98 and accompanying text.

274. See HAINES, BOWMAN, & WOLL, *supra* note 270, at 489-91 (collecting cases). The defendant is also entitled to a limited class of immediately available offsets. See *United States v. Flowers*, 55 F.3d 218, 222 (6th Cir. 1995) (finding loss in check kite is the "gross amount of the loss at the time of the detection of the fraud . . . , less funds available for offset . . . and secured collateral"); *United States v. Shaffer*, 35 F.3d 110, 114-15 (3d Cir. 1994) (holding in check-kiting scheme that loss is amount of outstanding bad checks at time of discovery less applicable offsets); *United States v. Marker*, 871 F. Supp. 1404, 1409 (D. Kansas 1994) ("[A]ctual loss should be calculated as it exists at the time of detection rather than at sentencing.").

275. 993 F.2d 1358, 1358-59 (8th Cir. 1993).



included the embezzled \$88,000, but not the misapplied \$318,915.<sup>276</sup> Likewise, in *United States v. Shattuck*,<sup>277</sup> the First Circuit indicated in dicta that the amount of “victim loss” in an embezzlement does not include the amount of misapplied funds that remained in a bank account.<sup>278</sup>

The Third and Seventh Circuits took a contrary position. In *United States v. Strozier*,<sup>279</sup> the Seventh Circuit held that where the defendant fraudulently deposited \$405,000 into a bank account, but withdrew only \$36,000, the loss was \$405,000.<sup>280</sup> In *United States v. Kopp*,<sup>281</sup> the Third Circuit discussed in dictum the situation of a hypothetical clerk who intends to withdraw the money, invest it, and then return it.<sup>282</sup> It noted that, while the “amount taken” would be the amount invested, if the clerk was successful and returned the money without detection, both the intended and actual loss would appear to be zero. The court appeared to view this as an unacceptable result, implying that the proper measure of loss was the whole amount.<sup>283</sup>

2. *The New Economic Crime Guidelines Adopt a Net Approach to Loss.*—Throughout the long process of forging an economic crime package, crediting loomed as a troublesome issue. As the previous section suggests, existing case law was extensive, dense, and often contradictory. The theoretical issues were complicated. Many of the interested parties had strong views on particular corners of the problem.<sup>284</sup> On balance the new guideline seems theoretically

276. *Id.* at 1359. The apparent theory was that there was not a “taking” as to the larger sum. For a discussion regarding the problems flowing from the use of the term “taken” in Guideline Section 2B1.1, Application Note 2. See *supra* notes 92-102.

277. 961 F.2d 1012 (1st Cir. 1992). *Shattuck* is cited with approval in *Johnson*, 993 F.2d at 1359 n.2.

278. 961 F.2d at 1017.

279. 981 F.2d 281 (7th Cir. 1992). *Strozier* is cited with approval in *United States v. Yusufu*, 63 F.3d 505, 513 (7th Cir. 1995).

280. 981 F.2d at 284.

281. 951 F.2d 521 (3d Cir. 1991).

282. *Id.* at 530 n.13.

283. The court says that “embezzlement, unlike ordinary theft or fraud, involves not only a taking but also an action akin to a breach of fiduciary duty, which might justify always using the amount taken as ‘loss’.” *Id.*; see also *United States v. Mount*, 966 F.2d 262 (7th Cir. 1992) (Easterbrook, J.). Defendant stole baseball playoff tickets with a face value of \$12,000 and sold them in a block to a scalper for \$30,000. *Id.* at 264-66. Integral to the scheme was the necessity of placing \$12,000 in the baseball team’s account to cover up the theft; presumably, the money would come from the sale to the scalper. *Id.* at 266. The court suggested defendant’s intention to repay, and perhaps his success in doing so, do not matter: “An embezzler who abstracts \$10,000 to invest in the stock market causes a ‘loss’ of \$10,000 even if he plans to repay before the next audit (to avoid detection) and even if he invests in only blue chip stocks.” *Id.* at 266.

284. See, e.g., 1997 *Hearing Excerpts*, *supra* note 106, at 164 (testimony of Judge Gerald Rosen regarding crediting rules in Ponzi scheme investment frauds); Pflaumer & Spearing, *supra* note 168 (discussing Justice Department concerns over crediting provisions of February 1998 draft loss definition).

sound and a fair accommodation of most of the most commonly expressed concerns.

The new economic crime guideline comes down firmly in favor of the proposition that loss is a measurement of economic harm to victims and therefore must be a measurement of *net* economic deprivation. It states as a general rule that: "Loss shall be reduced by . . . [t]he money returned, and the fair market value of the property returned and the services rendered, by the defendant or other persons acting jointly with the defendant, to the victim before the offense was detected."<sup>285</sup> In addition, the new guideline addresses two specific recurring problems in the area of credits against loss—the problem of investment fraud cases, and issues surrounding regulatory offenses and unlicensed professionals—and provides a timing rule for including credits.

The following sections will analyze the language of the general credits rule, as well as the particular provisions governing investment fraud, and regulatory offenses. Finally, I will address an issue not covered by the new guideline: items of *de minimis* value provided to victims by defendants. Discussion of the timing rule for credits will be deferred until the discussion in Part IV.E of timing of loss measurement.

3. *The Language of the New Crediting Rule.*—The new crediting rule contains one imprecise use of language that might have proven potentially troublesome were it not for the clarification provided by the Commission's statement of reasons.<sup>286</sup> The rule says loss is to be "reduced by . . . [t]he money *returned*, and the fair market value of the property *returned* and the services rendered, by the defendant . . ."<sup>287</sup> Read literally, the word "returned" might be construed to mean that the only things to be credited against loss are money or property that the defendant obtained from and later gave back to a particular victim. This reading would exclude from the crediting rule anything the defendant transferred to a victim that the victim had not possessed in the first place. For example, it would eliminate the credit explicitly provided under the former fraud guideline for the \$10,000 fair market value of stock purchased by a victim in reliance on the defendant's fraudulent misrepresentation that the stock was worth \$40,000.<sup>288</sup> In such a case, the defendant would not be "returning" the undervalued (but valuable) stock because the victim never owned it prior to the

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285. U.S.S.G. § 2B1.1, app. n.2(E)(i) (2001).

286. The new crediting rule contains a second verbal imprecision of primarily theoretical concern. It speaks of "reducing loss" by the value of money, property and services passing from the defendant to the victim prior to detection. Properly speaking, since loss is the net economic detriment suffered by the victim in consequence of the defendant's conduct as of the time of detection, loss is not "reduced" by the value of things transferred from the defendant to the victim. Rather, loss is *defined* as the difference in value between what the victim parted with and what the defendant transferred to the victim. For this reason, the CLC draft says that "[l]oss shall be determined by excluding" benefits provided to victims by defendants prior to detection. *Final Redefinition*, *supra* note 166, at 49. The difference is minor, but potentially valuable.

287. U.S.S.G. § 2B1.1, app. n.2(E)(i) (2001) (emphasis added).

288. *Id.* § 2F1.1, app. n.8(a) (2000).



fraudulent transaction.

A construction of the new rule based on a literal reading of the word “returned” would be disastrous, absurd in theory and exclude many cases the Commission plainly intended to cover. Fortunately, both the legislative history of the crediting provision, and more particularly, the Commission’s statement of reasons accompanying the new economic crime guideline, make clear that the Commission intends the crediting provision to be a general rule covering all economic benefits passing from the defendant to the victim prior to detection. In its statement of reasons, the Commission wrote:

The loss definition also provides for the exclusion from loss of certain economic benefits transferred to victims, to be measured at the time of detection. This provision codifies the “net loss” approach that has developed in the case law, with some modifications made for policy reasons. This crediting approach is adopted because the seriousness of the offense and the culpability of a defendant is better determined using a net approach. This approach recognizes that the offender who transfers something of value to the victim(s) generally is committing a less serious offense than an offender who does not.<sup>289</sup>

4. *Investment Fraud Cases.*—Under the former fraud guideline, courts adopted three different approaches to credits for amounts returned to the victims of investment schemes with more than one victim (such as so-called “Ponzi schemes”) in which the defendant repays money to early victims in order to continue the scheme or avoid detection. The Second, Fourth, Fifth, Sixth, and Ninth Circuits held that payments made to Ponzi scheme victims are not deductible from the “loss” figure.<sup>290</sup> The theory of these cases was that a defendant should receive no credit for such payments because they are a necessary part of the scheme designed to gain the investors’ confidence in order to secure additional investments and to forestall discovery of the scheme. The Seventh Circuit considered the victims as a class and took a net loss approach: the loss is the amount taken from the class of victims by the defendant minus the amount given back to the class of victims by the defendant.<sup>291</sup> The Eleventh Circuit found a middle ground, adopting a “loss to the losing victims”

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289. Statement of Reasons, *supra* note 117, at 30543.

290. *United States v. Munoz*, 233 F.3d 1117 (9th Cir. 2000); *United States v. Deavours*, 219 F.3d 400 (5th Cir. 2000); *United States v. Loayza*, 107 F.3d 257 (4th Cir. 1997); *United States v. Carrozzella*, 105 F.3d 796 (2d Cir. 1997); *United States v. Mucciante*, 21 F.3d 1228 (2d Cir. 1994); *United States v. Dobish*, 102 F.3d 760 (6th Cir. 1996). At one point, the Fifth Circuit seemed to be leaning toward the Eleventh Circuit’s “loss to the losing victims” approach, *see United States v. Krenning*, 93 F.3d 1257, 1269 (5th Cir. 1996) (“the focus of the loss calculation should be on the harm caused to the victim of the fraud,” *citing with approval*, *United States v. Orton*, 73 F.3d 331, 333 (11th Cir. 1996)), but the Fifth Circuit, in *Deavours* took a different course. 219 F.3d at 403.

291. *United States v. Holiusa*, 13 F.3d 1043, 1045-46 (7th Cir. 1994).

approach.<sup>292</sup> Under this theory, the loss is the total amount lost by those victims who were out money at the time of the scheme's discovery. Those investors who received repayments in excess of their original investment are not considered "victims" at all. Therefore, their windfalls are not counted towards reducing the losses of other investors.<sup>293</sup>

The refusal of the Second, Fourth, Fifth, Sixth, and Ninth Circuits to give credit for any payments to early investors was troublesome even as an interpretation of the former guidelines. The reasoning of these courts was even less persuasive as a guide to what the law should be. First, giving no credit for repayments ran contrary to the basic "net loss" approach embodied in former Section 2F1.1, Application Notes 8(a) and 8(b), as well as the plentiful case law endorsing the net loss approach.<sup>294</sup> Second, as a matter of policy, because the function of the loss figure is to measure economic harm to victims, it must distinguish between greater and lesser harms. A scheme in which a defendant takes and keeps \$10,000 causes more economic harm than one in which the defendant takes \$10,000, but gives back \$5000.

Third, the rationale for the court-created "Ponzi scheme exception" to the basic net loss rule—that defendants deserve no credit for payments made solely to perpetuate the scheme—if written into the guidelines as a caveat to the general rule that "actual loss" is a net concept, would swallow the general rule and eliminate virtually all credits.<sup>295</sup> No defendant truly bent on fraud confers benefits on his victims out of benevolence or a sense of sound commercial ethics. Any swindler who can will steal without incurring any overhead. Thus, almost all payments and transfers by defendants to victims are made in some sense to further the success of the scheme.

Consider four cases: (A) a man steals my wallet containing \$10,000; (B) a man convinces me to give him \$10,000 in exchange for stock he knows to be worth \$5000; (C) a man convinces me to give him \$10,000 in exchange for his promise to pay me \$13,000 next Tuesday, but actually pays me only \$8000 (hoping that this payment will be sufficient to prevent me from going to the police); and (D) a man lies about his assets and convinces me to loan him \$10,000 in exchange for an unfulfilled promise to repay the money with interest, collateralized by a security interest in real property worth \$9000. Assume in each case that the defendant's purpose throughout was to steal. Under a crediting rule with a "perpetuation" exception, the defendant who steals my wallet with \$10,000 in it, of course, gets no credit because he gave nothing back. The defendant who gave me stock he knew to be worth only \$5000 in return for my

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292. *United States v. Orton*, 73 F.3d 331, 334 (11th Cir. 1996).

293. *See id.*

294. *See supra* notes 270-73 and accompanying text.

295. The tendency of these investment cases to erode the general net loss principle can be seen in *United States v. Blitz*, 151 F.3d 1002, 1012 (9th Cir. 1998), in which the court denied defendant telemarketers credit for pre-detection refunds and other payments to victims on the ground that such payments were merely necessary incidents to the execution of the scheme. The court equated such payments with defendants' payment of their phone bills.



\$10,000 would, under a “perpetuation” rule, get no credit for the \$5000 because the purpose of giving it to me was to convince me to part with my money and to avoid criminal prosecution by giving me something of arguable economic value. Likewise, neither the defendant who made a partial payment of \$8000 in order to dissuade me from going to the police, nor the defendant who pledged \$9000 in collateral to obtain the loan, would be credited. In each of the cases above, the defendant gave me money or property in order to convince me to part with my own or to forestall apprehension and punishment. Consequently, a “perpetuation exception” has the effect of wiping out the general principle that “loss” is a net concept, and therefore the effect of treating identically cases in which the economic harm to the victims is incontestably quite different. In investment fraud schemes as elsewhere, the difference in harm caused should be reflected in the sentence imposed.

The Seventh Circuit’s approach of considering the net loss to the victim investors as a class was likewise questionable because windfalls bestowed on early investors in a Ponzi scheme do nothing to reduce the harm inflicted on later investors left holding the bag.<sup>296</sup>

In its new economic crime guideline, the Commission expressly adopted the Eleventh Circuit’s “loss to the losing victims” approach to multi-victim fraud schemes.<sup>297</sup> Accordingly, the new loss definition provides that:

In a case involving a fraudulent investment scheme, such as a Ponzi scheme, loss shall not be reduced by the money or the value of the property transferred to any individual investor in the scheme in excess of that investor’s principal investment (i.e., the gain to an individual investor in the scheme shall not be used to offset the loss to another individual investor in the scheme).<sup>298</sup>

5. *Regulatory Offenses and Unlicensed Professionals.*—Some of the knottiest problems presented by the net versus gross loss debate arose from cases in which defendants evaded FDA regulatory processes in bringing drugs to market. In one case, *United States v. Chatterji*, the defendant provided false information to the FDA to gain approval of a drug.<sup>299</sup> In another, *United States v. Haas*, the defendant purchased drugs in Mexico for sale in the United States,

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296. See *supra* note 291 and accompanying text.

297. “This amendment adopts the approach of the Eleventh Circuit that excludes the gain to any individual investor in the scheme from being used to offset the loss to other individual investors because any gain realized by an individual investor is designed to lure others into the fraudulent scheme.” Statement of Reasons, *supra* note 117, at 30544 (referring to *United States v. Orton*, 73 F.3d 331 (11th Cir. 1996)).

298. U.S.S.G. § 2B1.1, app. n.2(F)(iv) (2001). This language is taken virtually verbatim from the 2001 CLC Draft, see *Final Redefinition*, *supra* note 166, at 50, with the exception of the Commission’s substitution of “individual investor” for the CLC’s “investor.” The significance of the term “individual investor” is unclear. I take it to mean “single investor,” and not to convey any distinction between individual and institutional investors.

299. 46 F.3d 1336 (4th Cir. 1995).

thus bypassing FDA controls.<sup>300</sup> In both cases, the defendant sold drugs that were equally effective as those approved by the FDA. In *Chatterji*, the Fourth Circuit found no economic harm and therefore no loss,<sup>301</sup> while in *Haas*, the Fifth Circuit found no economic harm, but remanded the case to the district court for a determination of the defendant's sentence based on his gain.<sup>302</sup> A similar problem was presented in *United States v. Maurello*, where the Third Circuit held that a defendant convicted of mail fraud for deceiving clients by practicing law without a license must be credited in the loss calculation for the value of satisfactory legal services rendered.<sup>303</sup>

Some observers, notably including the Justice Department, argued that those who place consumers at risk by evading regulatory processes for drugs and other products and services should receive significant sentences. From a theoretical perspective, where Congress creates a regulatory authority to regulate risky activities such as the production of medicine, and a defendant intentionally circumvents that authority to make a profit, the fact that the defendant lucked out and did not hurt or kill anybody does not reduce the severity of the crime—or if it does, not by much. Consumers are entitled to rely on the regulatory process. They would not, as a rule, purchase products known to have been produced in defiance of regulatory safeguards. Thus, the entire amount paid for the improperly certified item is indeed a loss because it measures the out-of-pocket expense to fraudulently misinformed consumers. Alternatively, if we consider that the class of victims may include the defendant's competitors—companies that produce equivalent products in conformity with regulatory standards—the value of the defendant's sales is a fair measure of the loss to the defendant's competitors. The same arguments can fairly be made in cases involving unlicensed professionals.

In response to these concerns, the CLC proposed<sup>304</sup> and the Commission ultimately adopted a narrowly targeted exception to the crediting rule under which loss, by definition, includes the amounts paid by victims for

services . . . fraudulently rendered to the victim by persons falsely posing as licensed professionals; . . . goods . . . falsely represented as approved by a governmental regulatory agency; or . . . goods for which regulatory approval by a government agency was required but not obtained, or was obtained by fraud, with no credit provided for the value of those items or services.<sup>305</sup>

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300. 171 F.3d 259 (5th Cir. 1999).

301. 46 F.3d at 1342-43. Although in a later case involving nearly identical facts, *United States v. Marcus*, 82 F.3d 606 (4th Cir. 1996), the Fourth Circuit found the loss to be the value of the gross sales of an unapproved drug, distinguishing *Chatterji* on the ground that the modifications of the drug formula in *Marcus* affected the bioequivalence of the drug. *Id.* at 610.

302. 171 F.3d at 270.

303. 76 F.3d 1304, 1311-12 (3d Cir. 1996).

304. See *Final Redefinition*, *supra* note 166, at 49-50.

305. U.S.S.G. § 2B1.1, app. n.2(F)(v) (2001).



The new rule for measuring loss in regulatory cases also solves a technical problem in the area of “gain.” At various times during the economic crime sentencing debate, the Department of Justice pressed for an extension of the concept of “gain” to deal with regulatory evasion cases. The Department of Justice’s solution to the regulatory crime problem would have had a much greater distorting effect on the overall structure of the loss definition than would the newly adopted targeted provision for regulatory and unlicensed professional cases. The new guideline addresses legitimate concerns about imposing appropriate punishment for regulatory crimes without introducing the unpredictable complications that might well ensue from elevating “gain” to equal footing with “loss” as a measure of offense seriousness.

6. *Items of de minimis Value.*—The Justice Department repeatedly expressed concern about any rule that would require the court to credit defendants for the nearly worthless items sent by telemarketers in place of the items promised—five dollar plastic radios in place of the promised “stereo system,” common coins in place of the promised “rare collectibles,” etc. The Department was understandably concerned about two points: first, that such junk confers no real economic benefit on the persons receiving it, and thus should not reduce a defendant’s punishment, and second, that calculating the value of the stuff is, at best, a nuisance.

Responses to Justice Department concerns took two basic forms. Some loss redefinition proposals included language declining credits against loss for items of “de minimis” value transferred from defendants to victims.<sup>306</sup> Alternatively, Sentencing Commission staff suggested excluding from “loss” anything transferred to victims by defendants if the thing “has little or no value to the victim because it is substantially different from what the victim intended to receive.”<sup>307</sup> As phrased, this second approach had the potential to become a Trojan horse undermining uniform application of the net loss concept. The problem was the emphasis on whether the economic benefit conferred is of little or no value “to the victim because it is *substantially different from what the victim intended to receive.*”<sup>308</sup> In every fraud case, what the victim got was “substantially different from what the victim intended to receive.” If the victim got what he intended to receive, there would be no crime. And in many (perhaps most) cases, victims, if asked, will say that what they got is of little or no value *to them* because it was not what they bargained for, even if the thing transferred had substantial, measurable economic value. The effect of including this provision would have been to shift the focus of the loss determination from an objective consideration of the market value of whatever the defendant gave the victims to a subjective evaluation of what *the victim thinks* is the worth of what the defendant gave him.

In the end, the Commission included neither proposal in the new loss

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306. See, e.g., *Final Redefinition*, *supra* note 166, at 49-50.

307. *Id.* at 52.

308. *Id.* (emphasis added).

definition. As a result, courts will be obliged to address the effect on loss of allegedly *de minimis* benefits on a case-by-case basis.

### *E. Time-of-Measurement*

Critical to the practical problem of measuring loss is a determination of *when* loss should be measured. The time-of-measurement problem has two basic components. The first is the question of when to *value* the worth of stolen assets whose value fluctuates over time, such as stock, precious metals, coins, commodities, real estate, and the like. The second is when to *count* so-called “credits” against loss, such as transfers to victims as part of the scheme, repayments to victims, and posted collateral. The most common counting question is whether to reduce the loss amount by the value of things returned or conveyed to the victim after the crime has been detected. This second component of the time-of-measurement problem also has a sub-issue, in that there must be a rule for *when* to *value* those things *counted* as credits.

To illustrate both components of the time-of-measurement problem, assume that a telemarketer sells, and delivers to the victim, stock falsely represented to be worth \$1000, which is, at the time of the sale, actually worth \$300. The victim pays the telemarketer by giving him a quantity of gold, then valued at \$1000. Assume further that, after the fraud is detected, the telemarketer sends the victim a check for \$700. Assume still further that the true market value of the stock has dropped to \$200 as of the date of detection the fraud, but climbs up to \$400 by the time of sentencing. In the meantime, the value of the gold increases to \$1100 at the time of detection, but has dropped to \$900 by sentencing day. Ideally, guideline time-of-measurement rules should tell a sentencing judge: when to value the gold from which the victim was swindled; whether to reduce the amount of the loss by the value of the stock initially transferred to the victim; if so, when to value the stock transferred to the victim; and whether to reduce the amount of the loss by the amount of the \$700 check.

In my view, the most significant (and indeed only major) defect in the new loss definition is its failure to fully address the time-of-measurement problem. The new guideline contains time-of-measurement rules *only* for cases involving credits against loss: generally, defendants will be credited with things of value transferred to victims prior to detection, and in loan cases, defendants will be credited for collateral pledged by the defendant in “the amount the victim has recovered at the time of sentencing from disposition of the collateral, or if the collateral has not been disposed of by that time, the fair market value of the collateral at the time of sentencing.”<sup>309</sup> However, the new guideline contains no general time-of-measurement rule, and no rule about when to value credits other than collateral. The rule on measurements of credits against loss is sound, so far as it goes. The absence of any other timing rules is disappointing.

1. *The New Time-of-Measurement Rules for Crediting.*—The time to *count* “credits” against loss is the time of detection. If defendants were credited with

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309. U.S.S.G. § 2B1.1, app. n.2(E)(i)-(ii) (2001).



repayments made after detection, but before sentencing, the rich (or those who had not yet spent their criminal earnings) could buy themselves out of prison time.<sup>310</sup> The universal rule among those courts that considered the question under the former guidelines was that credits against loss such as transfers to victims, pledges of collateral, and repayments should be measured at the time of detection.<sup>311</sup> The Commission wisely codified this rule.

Second, it is equally clear that “credits” should not be *valued* prior to detection. Early Commission drafts suggested that things of value transferred by a defendant to a victim and credited against loss should be valued at the *time of transfer*.<sup>312</sup> Establishing the value of credits at the time of transfer to the victim would prove terribly cumbersome in many multi-victim or multi-transaction cases, and would produce substantively erroneous and unfair results in certain cases.

Consider the following examples:

*a. Precious metals/rare coins boiler room.*—Defendants sell over the telephone to hundreds of victims supposedly “rare” coins or ingots of precious metals at vastly inflated prices. The defendants do send coins to the victims, and the coins have some value. However, the value of the coins is much less than represented *and* the value fluctuates over time. Here, the Commission staff’s proposed time-of-measurement rule would require the court to determine the date of every “transfer” of coins, and determine the value of the coins for every date on which a transfer occurred. In a routine boiler room case, this would involve hundreds or even thousands of different valuations.

*b. Stock fraud.*—Defendant makes an initial stock offering in the penny stock market, and makes inflated and untrue claims in the prospectus. Hundreds of victims buy the stock over a six month period, during which time the stock steadily gains in value. At the end of the six month period, the defendant’s falsehoods come to light and the value of the stock plunges to zero. In such a case, not only would the proposed “valuation at time of transfer” rule require the court to determine the fluctuating price of the bogus stock on every date on which there was a purchase, but it would produce the absurd result that the victims would be found to have no “loss” at all. Since the amount of money the

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310. See, e.g., *United States v. Wright*, 60 F.3d 240, 244 (6th Cir. 1995) (Batchelder, J., dissenting).

311. See, e.g., *United States v. Fraza*, 106 F.3d 1050, 1055 (1st Cir. 1997) (holding loss is amount of fraudulent loan not repaid at time offense was discovered); *United States v. Akin*, 62 F.3d 700, 701 (5th Cir. 1995) (rejecting argument of check-kiting defendant that the loss figure should be reduced by restitution payments made between time of discovery of kite and sentencing, and holding loss to be measured at time of discovery of scheme); *United States v. Flowers*, 55 F.3d 218, 220-22 (6th Cir. 1995) (holding in check-kiting scheme that loss is to be amount of outstanding bad checks, less any amount in accounts at time of discovery); *United States v. Shaffer*, 35 F.3d 110 (3d Cir. 1994) (time for determining loss is time crime is detected); *United States v. Frydenlund*, 990 F.2d 822, 825-26 (5th Cir. 1993) (rejecting argument that check-kiting should be treated like fraudulently obtained loan and instead measuring loss at time of discovery of scheme).

312. See, e.g., *Final Redefinition*, *supra* note 166, at 45-48.

victims paid to the defendant would be offset by a credit for the market value of the stock *on the date of transfer*, by definition the “loss” would be zero.

Similar phenomena occur in real estate schemes in which defendants succeed in inflating the market value of otherwise undesirable property. In all such schemes, measuring the value of the thing transferred to the victim at the time of transfer produces a loss of zero. The only way around this result is to argue that the “real” value of the transferred property at the time of the transfer was not its then-current market price, but the value it would have had if full information had been available. But this is nothing more than a roundabout way of saying that the value of transferred property in such cases is actually its value at the time of detection of the crime. So why not adopt that rule in the first place?

Happily, the Commission did not codify a rule requiring that credits against loss be valued at the time of transfer from the defendant to the victim. Unhappily, the Commission adopted no valuation rule at all for credits except in the case of pledged collateral. The rule governing collateral is at least consistent with pre-existing law.<sup>313</sup>

2. *Timing Issues Left to the Courts.*—As a consequence of the Commission’s abstention, sentencing courts will be obliged to develop some time-of-measurement rules by common law processes. In doing so, they may wish to consider the following points:

In theory, loss could be measured, and its constituent elements counted and valued, at any one of a number of points, including the time the crime is legally complete, the time of detection, or the time of sentencing. Moreover, one could envision time-of-measurement rules that counted the components of loss at one time, but valued them at another. We have already seen that some Commission loss definition drafts dealt with the crediting problem by *counting* as credits against loss only those transfers from defendants to victims made prior to detection, but *valuing* the things transferred to the victims as of the time of transfer.<sup>314</sup> Similarly, the January 2001 Staff Draft proposed as one option counting *and* valuing credits at the time of detection, while “measuring” (which I take to mean both counting and valuing) loss generally at the time of sentencing.<sup>315</sup>

In the view of a number of observers, including the Criminal Law Committee, to the extent possible, all the elements of the loss calculation should be counted and valued at the same point in time.<sup>316</sup> Although there may be reasons to deviate in special cases from this principle, the greater the number of exceptions, the greater will be potential for confusion. A strong case can be

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313. Under the former fraud guideline, U.S.S.G. § 2F1.1, app. n.8(b) (2000), collateral was valued at either the amount obtained by the victim through foreclosure and liquidation, or if these events have not yet occurred by sentencing, at the fair market value at the time of sentencing. See HAINES, BOWMAN & WOLL, *supra* note 270, at 484-88.

314. See *supra* note 270 and accompanying text.

315. See January 2001 Commission Draft, *supra* note 177, at 7994..

316. See *Final Redefinition*, *supra* note 166, at 50; CLC Comments, *supra* note 182, at 41; Bowman, *supra* note 178, at 487.



made that the most desirable point at which to measure loss is the time of detection.

I have already addressed the arguments in favor of both counting and valuing credits against loss at the time of detection, arguments which the Commission found at least partially persuasive. The knottier question remains when to measure loss more generally, or to put it another way, when to count and value those components of loss not involving credits. The argument favoring the CLC position that loss should be measured at the time of detection may be summarized in this way: First, time-of-detection makes the best sense as the moment at which to “freeze the action” for purposes of measurement. Once a crime is discovered by its victims, they can take steps to prevent further losses. Likewise, once a crime is detected, defendants will ordinarily stop their criminal behavior, either because they have been arrested or because they fear arrest and do not wish to make their punishment worse. Thus, in the ordinary case, the time of detection will be the point of maximum loss.<sup>317</sup> Additionally, even though losses may sometimes continue to accrue after detection up until sentencing despite the cessation of a defendant’s active criminal efforts, there is far too great a potential for arbitrariness in measuring loss at the date of sentencing. For example, defendants should not have to spend more time in prison because losses mount while the government or the court delays a prosecution or sentencing.<sup>318</sup>

Nonetheless, a case can be made for counting and valuing the “non-credit” components of loss at the time of sentencing. In the first place, there is at least some potential tension between a time-of-detection measurement rule and the basic definition of loss as “reasonably foreseeable pecuniary harm that resulted from the offense.”<sup>319</sup> Presumably, some of the harms that fall within this definition will not manifest themselves until some time after the moment the crime is detected. Moreover, one could argue that the valuation problem would be made somewhat simpler because probation officers and other experts preparing for sentencing could look to current market values of assets, as opposed to ascertaining those values at the earlier time of detection. However, I confess to finding the valuation argument unconvincing, as I doubt that in most cases valuing assets on a past date certain would prove any more difficult than providing a current market value.

The CLC proposed the following rules, which courts may find of persuasive

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317. Of course, if a defendant persisted in committing additional criminal conduct leading to new losses after detection of the scheme, this rule would not cut off his sentencing liability for the new losses because the additional conduct would not yet have been “detected” for purposes of the rule.

318. See, e.g., *United States v. Stanley*, 54 F.3d 103 (2d Cir. 1995). In *Stanley*, a bank trust officer bought bonds at a high price for trust clients of a bank. As the bonds began to devalue, the officer misstated their value in bank records and in statements sent to clients. As a result, neither the bank nor clients could act to sell and stem losses. *Id.* at 104. The court calculated loss as the amount of devaluation in period between misstatements to bank and customers and the time at which fraud was discovered. *Id.* at 106.

319. U.S.S.G. § 2B1.1, app. n.2(A)(i) (2001).

value when considering time-of-measurement problems not covered by the new guideline:

Time of measurement: Loss should ordinarily be measured at the time the offense was detected.

- (i) For purposes of this guideline, an offense is detected when the defendant knew or reasonably should have known that the offense was detected by a victim or a public law enforcement agency.
- (ii) Except as provided in subsection (D)(iii), the value of any “economic benefit” transferred to the victim by the defendant for purposes of Subsection (C) shall be measured at the time the offense was detected.
- (iii) However, in a case involving collateral pledged by a defendant, the “economic benefit” of such collateral to the victim for purposes of Subsection (C) is the amount the victim has recovered at the time of sentencing from disposition of the collateral. If the collateral has not been disposed of by that time, the “economic benefit” of the collateral is its value at the time of sentencing.<sup>320</sup>

These proposed rules embody the principle that, in general, all components of “loss” should be measured at the time of detection. This means that the money or property obtained by the defendant from the victim, *and* the money or property transferred back to the victim from the defendant during the course of the scheme, should all be counted and valued as of the date of detection. The only exception to this general rule is the valuation of pledged collateral, which the CLC, like the Commission itself, retained for reasons of ease of administration and continuity with existing practice.

#### *F. Gain*

The former fraud guideline provided that a defendant’s “gain” from his offense might be used as a means of estimating the loss: “The offender’s gain from committing a fraud is an alternative estimate that ordinarily will underestimate the loss.”<sup>321</sup> This provision was directed primarily at situations such as large telemarketing frauds with numerous victims in which precise determination of the exact loss suffered by the victim class is difficult or impossible, but an examination of the defendant’s records permits a good estimate of the amount the defendant gained from the crime. It was also useful in cases in which the former larceny-based loss definition made it difficult to

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320. See *Final Redefinition*, *supra* note 166, at 50.

321. U.S.S.G. § 2F1.1, app. n.9 (2000).



identify the true victim(s) of the offense.<sup>322</sup> Three major questions about gain were decided during the course of the debate over the economic crime package.

1. *The New Economic Crime Guideline Retains "Gain" as a Method of Estimating Loss.*—It has been argued that a separate provision addressing a defendant's "gain" is superfluous in a properly drafted loss guideline because "gain" is unnecessary if the victims of defendant's conduct are accurately identified.<sup>323</sup> However, other observers argued persuasively that there are some cases, particularly frauds involving numerous victims with small individual losses, in which proving loss directly victim-by-victim is prohibitively difficult.<sup>324</sup> In such cases, it makes good sense to have gain available as a means of approximating loss. The new economic crime guideline treats gain in just this way stating that "The court shall use the [defendant's] gain that resulted from the offense as an alternative measure of loss only if there is a loss but it reasonably cannot be determined."<sup>325</sup>

The final guideline correctly abandoned the approach of several earlier drafts that proposed using gain "instead of"<sup>326</sup> or as "an alternative measure of"<sup>327</sup> loss where "gain is greater than loss and more accurately reflects the seriousness of the offense."<sup>328</sup> This approach was freighted with problems. As the judges of the CLC observed:

The Committee urges the Commission to view with caution proposals that treat "gain" as having independent significance. The loss tables are established on the assumption that they measure relative amounts of economic harm inflicted on victims of crime. As long as "gain" is merely an occasionally useful way of estimating "loss," treating a "gain" of \$X the same as a "loss" of \$X makes sense because the defendant's gain is some victim's loss. Some of the pecuniary gain options in the Commission Proposal assume, however, that there are cases in which the defendant receives a "gain," but does not cause a corresponding amount of economic harm, either because he causes no economic harm at all or because the amount of the gain is greater than the amount of the loss. (§ 2.(E) [Options 2 and 3])<sup>329</sup> If such cases exist, then in such cases it seems doubtful that gain should have the same effect on punishment as

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322. See Bowman, *Coping with "Loss,"* *supra* note 103, at 508-09, 536-37.

323. *Id.* at 508.

324. See, e.g., Carol C. Lam, *Assessing Loss in Health Care Fraud Cases*, 10 FED. SENT. 145, 147 (1997) ("It is, of course, logistically impossible to prove widespread fraud on a patient-by-patient, claim-by-claim basis in a medical practice that had thousands of patients, each of whom received multiple services.")

325. U.S.S.G. § 2B1.1, app. n.2(B) (2001).

326. See, e.g., *Final Redefinition*, *supra* note 166, at 48.

327. January 2001 Commission Draft, *supra* note 177, at 7994.

328. See, e.g., *Final Redefinition*, *supra* note 166, at 48.

329. The reference here is to the Sentencing Commission staff proposal published in January 2001. See January 2001 Commission draft, *supra* note 177.

loss. In any case in which the “loss” is truly zero, or in which a defendant’s gain exceeds the economic loss to all identifiable victims, gain is no longer a true measurement of economic harm. The Committee is unsure of the justification for sentencing the defendant to the same punishment he would have received if he had caused a harm equal to his gain.<sup>330</sup>

Assume two cases. Defendant A steals \$100 from Victim, as a result of which he somehow “gains” \$1000. Defendant B simply steals \$1000 from Victim. The rule proposed in the January 2001 Commission draft and critiqued by the CLC would have punished Defendant A equally with Defendant B, even though Defendant B stole *ten times* as much money from and caused ten times as much economic harm to Victim. There is no justification either in criminal law theory, or in common sense, for such a result.

2. *Gain and Regulatory Fraud.*—A good deal of the debate over “gain” flowed from very particular Justice Department concerns about a series of appellate decisions finding no loss in cases where pharmaceutical manufacturers sold efficacious drugs after fraudulently obtaining FDA approval to do so, and requiring sentencing courts to offset against loss the value of useful services provided by unlicensed doctors and lawyers.<sup>331</sup> The proposals to allow the use of gain “instead of” loss, or as “an alternative measure” of loss when gain is greater than loss, were crafted primarily with these cases in mind. As discussed above, to address Justice Department concerns, the CLC proposed a special crediting rule, which in effect, defines loss in regulatory fraud cases as the gross amount paid by victims for goods or services fraudulently misrepresented as having regulatory approval or as being provided by a licensed professional.<sup>332</sup> Once this rule (now incorporated in the economic crime guideline<sup>333</sup>) seemed assured of passage, the Justice Department lost interest in an expansive definition of gain.

3. *The Rejected Downward Departure for “Gain.”*—A number of commentators from the defense community argued forcefully that in cases where a defendant’s personal gain is substantially less than the loss to the victim resulting from the offense, the Guidelines should provide for an encouraged downward departure.<sup>334</sup> The rationale for such a departure was said to be that a defendant who causes a large economic loss, but receives relatively little personal benefit from the crime, is less culpable than a defendant who garners all or a

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330. Committee on Criminal Law, Judicial Conference of the United States, *Criminal Law Committee Comments on Proposed Changes to “Loss” Definition*, 13 FED. SENT. REP. 41 (2000) (internal footnote added).

331. See *supra* notes 299-305 and accompanying text.

332. See *supra* notes 304-05 and accompanying text (discussing genesis of CLC proposal on measuring loss in regulatory fraud cases).

333. U.S.S.G. § 2B1.1, app. n.2(F)(v) (2001).

334. The most forceful exponent of this view was James E. Felman of the Practitioners’ Advisory Group. See *Symposium Proceedings*, *supra* note 175, at 62 (remarks of James E. Felman during the Third Plenary Session of the October 2000 Sentencing Symposium on Economic Crime).



large portion of the victim's loss for himself.<sup>335</sup> A departure on this ground was proposed in several drafts of the new economic crime guideline; however, no such departure appears in the final version.<sup>336</sup> This omission does not categorically preclude a departure based on a defendant's small personal gain. Nonetheless, such a departure would be an "unmentioned," rather than an "encouraged," departure under the taxonomy of *Koon v. United States*.<sup>337</sup>

### G. *Intended Loss*

1. *The Theory of Including Intended Loss in Economic Crime Sentencing.*—All of the sections of the new economic crime guideline discussed so far have concerned defining and measuring the actual losses inflicted by defendants. We now turn to "intended loss." The new economic crime guideline retains the rule of the former fraud guideline that where the loss a defendant *intended* to inflict was larger than the loss the victim actually sustained, the larger intended loss figure should be used to calculate the sentence.<sup>338</sup> Before addressing the

335. *Id.*

336. U.S.S.G. § 2B1.1, app. n.15(B) (Downward Departure Considerations) (2001).

337. 518 U.S. 81, 95-96 (1996) (creating a three-tiered structure for reviewing departures under Guideline Section 5K2.0, with different standards of review for encouraged, prohibited, and unmentioned factors). For analyses of the *Koon* case, see Bowman, *supra* note 201, at 23-24; Frank O. Bowman, III, *Places in the Heartland: Departure Jurisprudence After Koon*, 9 FED. SENT. REP. 19 (1996); and Barry L. Johnson, *Discretion and the Rule of Law in Federal Guideline Sentencing: Developing Departure Jurisprudence in the Wake of Koon v. United States*, 58 OHIO ST. L.J. 1697 (1998).

338. Compare U.S.S.G. § 2B1.1, app. n.2(A)(i) (2001), with U.S.S.G. § 2F1.1, app. n.8 (2000) ("[I]f an intended loss that the defendant was attempting to inflict can be determined, this figure will be used if it is greater than the actual loss."). For cases construing the former intended loss provision, see, for example, *United States v. Smith*, 62 F.3d 1073, 1079 (8th Cir. 1995) (credit card fraud defendant responsible for total amount of unauthorized charges, receiving no credit for items obtained by fraud, but later recovered); *United States v. Alonso*, 48 F.3d 1536, 1547 (9th Cir. 1995) (holding in credit card fraud case that loss equals greater of actual or intended losses); *United States v. Mizrahi*, 48 F.3d 651, 657 (2d Cir. 1995) (upholding district court's use of intended loss in amount of face value of policy taken out by defendant on property he burned); and *United States v. Watkins*, 994 F.2d 1192 (6th Cir. 1993) (formulating test for when defendant responsible for intended loss: Defendant intended the loss; it was possible for the defendant to cause the loss; and the defendant must have completed or been about to complete all acts necessary to bring about the loss.). In *United States v. Kopp*, 951 F.2d 521 (3d Cir. 1991), the court stated:

[F]raud "loss" is, in the first instance, the amount of money the victim has actually lost (estimated at the time of sentencing), not the potential loss as measured at the time of the crime. However, the "loss" should be revised upward to the loss that the defendant intended to inflict, if that amount is higher than actual loss.

*Id.* at 535-36. Similarly, in *United States v. Chevalier*, 1 F.3d 581, (7th Cir. 1993), the Seventh Circuit Court of Appeals stated:

In calculating the amount of fraud, the district court was required to find the amount of

specifics of the new rules on intended loss, it is useful to pause and consider the place of intended loss in the overall scheme of sentencing economic crime.

A measurement of actual loss caused by a defendant's criminal conduct is an appropriate component of the sentencing calculation because, as noted above, it measures actual harm and serves as a proxy measurement for other offense seriousness factors like state of mind. By contrast, because "intended loss" is only used when it exceeds actual loss, it is a measurement of harms that never happened.

The Sentencing Commission provides an increase in offense level for "intended loss" in both the old and new economic crime guidelines for the same reasons that substantive criminal liability is imposed for inchoate crimes like attempt and conspiracy.<sup>339</sup> First, criminal law is preeminently concerned with blameworthiness. We punish when, and because, punishment is deserved.<sup>340</sup> While the occurrence of harmful results is ordinarily a prerequisite for criminal liability, to some degree punishment on that basis has more to do with luck than desert. Would-be killers who shoot straight are punished for murder while those who don't are not. Nonetheless, we punish unconsumated efforts to cause harm as "attempts" or "conspiracies" (albeit usually less severely than completed crimes) so long as the would-be perpetrator has come close enough to success that we can be confident his malignant designs were real and not mere fantasy, and thus that his conduct was morally blameworthy.<sup>341</sup> Second, we punish the

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money the victim has actually lost (estimated at the time of sentencing), not the potential loss as measured at the time of the crime. However, the "loss" should be revised upward to the loss that the defendant intended to inflict, if that amount is higher than the actual loss.

*Id.* at 585-86.

Many courts held the same rule applicable to theft crimes, despite the absence of language in former Section 2B1.1 applying the intended loss rule generally to such cases. *See, e.g.,* United States v. Offiong, 83 F.3d 430, 1996 WL 195547 (9th Cir. 1996) (unpublished disposition) (applying Guideline Section B1.1, Application Note 4 presumption of \$100 per credit card intended loss in stolen credit card case); United States v. Sowels, 998 F.2d 249, 251 (5th Cir. 1993) (same); United States v. Chapdelaine, 989 F.2d 28, 35 (1st Cir. 1993) (applying intended loss in an attempted robbery case, and noting Guideline Section 2X1.1, Application Note 2, which states that, "in an attempted theft the value of the items the defendant attempted to steal would be considered"); United States v. Hernandez, 952 F.2d 1110, 1118 (9th Cir. 1991) (holding intended loss an appropriate component of sentencing calculation for tape counterfeiting defendant sentenced under Guideline Section 2B1.1).

339. *See generally* Richard Buxton, *The Working Paper on Inchoate Offenses: (1) Incitement and Attempt*, 1973 CRIM. L. REV. 656, 660.

340. *See, e.g.,* United States v. Studevent, 116 F.3d 1559, 1562-64 (D.C. Cir. 1997) (rejecting defendant's argument that actual loss is the dominant focus of the guidelines, and hence there should be an impossibility limitation on intended loss because in part, "One of the Guidelines' goals is to tailor punishment to a defendant's particular degree of culpability.").

341. Criminal liability for the crime of conspiracy requires evidence of some fixity of purpose in the form of an agreement with one or more co-conspirators. United States v. James, 528 F.2d



unsuccessful criminal not only because he deserves it, but because his frustrated plans present a high enough risk of actual harm that the utilitarian justifications for punishment dictate a dollop of deterrence.

The idea of basing punishment for economic crime on intended loss is grounded in the same moral and utilitarian considerations that impose substantive liability for attempts and conspiracies. Morally, we may consider that a swindler who intends to take a large amount of money is more culpable, and thus deserves a greater punishment, than one who seeks or secures a smaller amount.<sup>342</sup> From the utilitarian perspective, use of intended loss imposes punishment consequences (and thus, one hopes, achieves a deterrent effect) proportional to the degree of risk the defendant's behavior posed to the economic well-being of his fellow citizens, as measured by the magnitude of his criminal objectives.

2. *The Language of the New Intended Loss Rule.*—The new economic crime guideline says simply that “loss is the greater of actual or intended loss.”<sup>343</sup> By contrast, in its May 1999 draft, the staff suggested as Option 2 that loss be defined as either “the sum of actual loss and any additional intended loss” or “the sum of actual loss and any intended loss not resulting in actual loss.”<sup>344</sup> The Commission was ultimately unpersuaded by this approach.

There are certainly cases in which the defendant desired to cause pecuniary harm in addition to the actual harm that his conduct did indeed cause. But the vast majority of such cases are already accounted for by the present rule. Consider, for example, a defendant who intends to defraud his victims of \$100,000, but only succeeds in getting away with \$50,000 before being caught. In such a case, the staff proposal would have added the \$50,000 actually stolen to the additional \$50,000 the defendant wanted to steal, but couldn't, and get a loss of \$100,000. The rule adopted by both the new and former guidelines dictates the identical result because the \$100,000 loss the defendant intended

999, 1012 (5th Cir. 1976); *State v. Burns*, 9 N.W.2d 518, 520 (Minn. 1943). Moreover, a conspiracy normally requires an overt act in furtherance of the conspiracy committed by one of the conspirators. *United States v. Offutt*, 127 F.2d 336, 338 (D.C. Cir. 1942). Attempt liability customarily requires the commission of a “substantial step” toward accomplishment of the criminal goal. MODEL PENAL CODE § 5.01(2) (1985). See also Buxton, *supra* note 339, at 660.

The law of Attempt limits its deterrent and preventive role in the interests of freedom by requiring action, of some sort, as well as intention, on the part of the accused; in the same way as in substantive crime the deterrent and preventive role of the law is to some degree limited by the requirement of *mens rea*.

342. See *Studevent*, 116 F.3d at 1563 (“Limiting intended loss to that which was likely or possible . . . would eliminate the distinction between a defendant whose only ambition was to make some pocket change and one who plotted a million dollar fraud.”)

343. U.S.S.G. § 2B1.1, app. n.2(A) (2001). Neither the former nor new Guidelines, nor any of the draft proposals on redefining loss, amplify the meaning of the word “intended.” Drawing on general criminal law principles, it is fair to conclude that the intended loss is the harm the defendant either desired to cause or was practically certain would result from his offense. Whether any language making this point explicit should be included in the Guidelines remains an open question.

344. See, e.g., *Final Redefinition*, *supra* note 166, at 47.

*already includes* the \$50,000 the defendant succeeded in stealing. The staff's proposal was an attempt to address those cases in which a defendant intends to cause a loss in addition to the actual loss, and the actual loss figure includes economic harms reasonably foreseeable to the defendant, but not specifically intended by him. There are no doubt some such cases. There is, however, reason to doubt that they are sufficiently common to make it worthwhile to complicate the definition of loss. In any event, the Commission did not find it so.

3. *Impossibility and "Economic Reality."*—Should a defendant be held responsible for losses he subjectively desired and intended to inflict even if the achievement of his criminal goals was impossible, or at the least highly improbable? This question arose under the former theft and fraud guidelines in two types of cases, those involving government "sting" operations where no loss was possible because the defendant was dealing with government agents, and those in which the defendant's objectives were either impossible or improbable for some other, usually economic, reason. There was a divergence of views among the circuits on both types of cases.

a. *"Sting" operations.*—Defendants caught by government undercover operations before they stole any money commonly argued that the intended loss provision of former Section 2F1.1, Application Note 8, should not apply to them because no actual loss was possible. The majority of the circuits to have addressed the question rejected this argument and treated fraud cases no differently than drug cases or other "stings" in which success is foreclosed by the defendant's choice of confederate.<sup>345</sup>

The Tenth Circuit, however, took a different view. In *United States v. Galbraith*,<sup>346</sup> the court wrote that where the defendant is dealing with a government agent and no money changes hands, there is no loss.<sup>347</sup> The thesis was that, because "loss" is supposed to measure economic harm, in a situation where no harm could have occurred, the loss is zero. The *Galbraith* court relied heavily on *United States v. Santiago*.<sup>348</sup> In *Santiago*, the defendant falsely reported to his insurance company that his car had been stolen and submitted a

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345. See *United States v. Klisser*, 190 F.3d 34, 36 (2d Cir. 1999) (holding fact that defendant attempted to conspire with undercover agent does not make intended loss zero); *United States v. Schlei*, 122 F.3d 944, 995-96 (11th Cir. 1997) (sentencing guidelines permit enhancement for sentences based on defendant's intended loss in sting operation); *Studevent*, 116 F.3d at 1561 (loss calculation includes stolen checks passed to undercover FBI agent despite fact they would never be cashed); *United States v. Robinson*, 94 F.3d 1325, 1329 (9th Cir. 1996) ("There is no reason why defendants caught as a result of a sting operation should be treated any differently than defendants caught participating in an ongoing fraud."); *United States v. Falcioni*, 45 F.3d 24, 27 (2d Cir. 1995) ("Simply because the government's crime prevention efforts prove successful . . . does not mean the 'intended loss' is zero."); *United States v. Yellowe*, 24 F.3d 1110, 1112-13 (9th Cir. 1991) (applying intended loss provision of Section 2F1.1 where defendant enters into a scheme with a government informant to make unauthorized credit card charges).

346. 20 F.3d 1054, 1058-1060 (10th Cir. 1994).

347. See also *United States v. Sneed*, 34 F.3d 1570 (10th Cir. 1994) (accord).

348. 977 F.2d 517 (10th Cir. 1992).



claim for \$11,000.<sup>349</sup> Because the police intervened, the claim was not processed, but had it been, the maximum the company would have paid would have been the car's "blue book" value of \$4800.<sup>350</sup> The court concluded that the "intended loss" thus could not "exceed the loss a defendant in fact could have occasioned if his or her fraud had been entirely successful," in this case \$4800.<sup>351</sup>

It is doubtful that *Santiago* compels the result in *Galbraith*. First, literal application of the *Santiago* standard to the facts of *Galbraith* produces a result contrary to the one reached by the court. If Galbraith's "fraud had been entirely successful," he would have secured over \$600,000.<sup>352</sup> To say that Galbraith "could not have succeeded" because he was dealing with government agents is the same as saying that Santiago "could not have succeeded" because the police found about his scam before the claim could be processed.

The Tenth Circuit was apparently attempting to import into fraud sentencing a version of the principles of criminal liability concerning mistake of fact, or perhaps the doctrine of impossible attempts. Even if those principles have a place in sentencing law, the Tenth Circuit does not appear to have applied them properly to the facts of *Santiago*. A defendant claims *mistake of fact* when he wishes to establish that he lacked the requisite culpable mental state necessary to establish criminal liability. The claim will be effective only where the mistaken belief, if honestly held, would negate or disprove the existence of the required mental state.<sup>353</sup> Modern law concerning the doctrine of *impossible attempts* looks at the facts as defendant believed them to be. If he either did everything he could do to complete the transaction, or performed a substantial step toward completion, and the completed transaction would have constituted a crime if the facts were as he thought them, he is guilty of attempt.<sup>354</sup>

If Santiago honestly believed that his insurance claim could yield \$11,000, it is hard to see why he is not guilty of at least an attempt to defraud the company of \$11,000. At a minimum, and as the *Santiago* court held, his over-optimistic goals certainly do not relieve him of liability for the \$4800 loss that would have occurred without the vigilance of the police. Likewise, the question in *Galbraith* is whether, if the facts were as Galbraith believed them to be, he could have succeeding in defrauding his putative victims of over \$600,000. The answer is plainly yes. The Tenth Circuit's *Galbraith* opinion creates the arguably

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349. *Id.* at 519.

350. *Id.*

351. *Id.* at 524.

352. *Galbraith*, 20 F.3d at 1059.

353. MODEL PENAL CODE § 2.04(1)(a) (1985).

354. *Id.* §§ 2.04(2), 5.01. *See also* United States v. Thomas, 13 U.S.C.M.A 278, 32 C.M.R. 278 (C.M.A. 1962) (servicemen guilty of attempted rape of deceased woman with whom they had intercourse where they believed her to be alive, but unconscious and thus incapable of consent, at the time of the act). *But see* United States v. Berrigan, 482 F.2d 171, 188-89 (3d Cir. 1973) (reversing convictions for sending letters into and out of a federal penitentiary "without the knowledge and consent of the warden" because, unbeknownst to defendants, their courier had the warden's consent to carry the letters).

anomalous situation that a defendant can be sentenced based on the amount of nonexistent narcotics he attempted to buy from a government agent, but not on the amount of money he attempted to swindle from the same agent.<sup>355</sup>

*b. General impossibility or improbability.*—In *Galbraith*, the Tenth Circuit also relied on the Sixth Circuit's opinion in *United States v. Watkins*<sup>356</sup> and its own work in *United States v. Smith*, where it held that to meet the requirements of Section 2F1.1, "the record must support by a preponderance of the evidence the conclusion that Mr. Smith realistically intended a \$440,896 loss, *or that a loss in that amount was probable.*"<sup>357</sup> These two opinions are exemplars of a line of cases that attempted to impose an outer limit on the scope of "intended loss" defined by a notion of "economic reality." Some of the early cases in this line, including *Smith*, seem to have drawn inspiration from the reference to "probable" loss in the pre-1991 guidelines,<sup>358</sup> a term later omitted.<sup>359</sup> Even after that amendment, some courts continued to consider the probability of success of defendants' schemes.<sup>360</sup> However, the majority position regarding the former

355. The Ninth Circuit notes this anomaly in *United States v. Robinson*, 94 F.3d 1325, 1329 (9th Cir. 1996), and cites it as a reason to reject the impossibility argument regarding intended loss.

356. 994 F.2d 1192, 1196 (6th Cir. 1993) (formulating test for when defendant responsible for intended loss: defendant intended the loss; it was possible for the defendant to cause the loss; and the defendant must have completed or been about to complete all acts necessary to bring about the loss.); *see also* *United States v. Moored*, 38 F.3d 1419 (6th Cir. 1994). In *Moored*, the Sixth Circuit discussed the "'probable' loss contemplated by section 2F1.1." *Id.* at 1425. *Moored* adopts the reasoning and language of *United States v. Smith*, 951 F.2d 1164 (10th Cir. 1991), saying that "the record must support, by a preponderance of the evidence, a conclusion that [the defendant] realistically intended a loss of more than \$1,700,000." *Id.* (emphasis added). Later, the court said:

Clearly, it would have been proper for the district court to enhance Defendant's offense level if there was sufficient evidence in the record that Defendant did not intend to repay the loan, or even if there was proof in the record that Defendant had no realistic means to pay the loan.

*Id.* at 1429. As a practical matter, the court seems to suggest that once a defendant asserts an intention to repay money, the government must affirmatively disprove that claim.

357. *Smith*, 951 F.2d at 1168 (emphasis added).

358. *See, e.g.*, *United States v. Dozie*, 27 F.3d 95, 99 (4th Cir. 1994) (affirming district court's use of "economic reality" to limit fraud loss calculation, and relying on reference in former version of Guideline Section 2F1.1, app. n.7, to "probable or intended loss").

359. U.S.S.G. App. C, amend. 393 (1991).

360. In *United States v. Egemonye*, 62 F.3d 425 (1st Cir. 1995), the First Circuit sent equivocal signals. The court upheld the district court's assessment of loss in a stolen credit card scheme as the aggregate credit limits of all the stolen cards, saying: "Where there is good evidence of intent *and some prospect of success*, we do not think that a court needs to engage in more refined forecasts of just how successful the scheme was likely to be." *Id.* at 429 (emphasis added). *See also* *United States v. Ensminger*, 174 F.3d 1143, 1146 (10th Cir. 1999) (holding no loss enhancement appropriate where fraud had not even a remote possibility of success); *United States v. Sung*, 51 F.3d 92, 95 (7th Cir. 1995) (rejecting \$960,000 loss calculation in product counterfeiting scheme that government based on capacity of empty counterfeit cartons purchased



theft and fraud guidelines was that the “amount of loss that the [defendants] intended to inflict does not have to be realistic.”<sup>361</sup>

The new economic crime guideline codifies the majority view on both sting cases and the economic reality doctrine. It states that: “‘Intended loss’ (I) means the reasonably foreseeable pecuniary harm that was intended to result from the offense; and (II) includes intended pecuniary harm that would have been impossible or unlikely to occur (e.g., as in a government sting operation, or an insurance fraud in which the claim exceeded the insured value).”<sup>362</sup>

### *H. Enhancements*

With the exception of the “more than minimal planning” adjustments in both the former theft and fraud guidelines,<sup>363</sup> and the “scheme to defraud more than one victim” adjustment in the former fraud guideline,<sup>364</sup> which were deleted and built into the loss table beginning at \$120,000, the new economic crime guideline retains all the offense level enhancements of both the former theft and fraud guidelines. The new guideline adds a new enhancement for offenses involving numerous victims.<sup>365</sup> These changes are related to one another, and to the enhancement for “sophisticated means” added in 1998.<sup>366</sup>

The former theft and fraud guidelines were criticized for taking inadequate account of the defendant’s culpable mental state. Two indices of mental state in an economic offense are the complexity of the scheme and the number of victims adversely affected by the defendant’s crime. A complex scheme requires more planning and deliberation than an impulsive one. A scheme to steal from many victims suggests a more abandoned mental state than a scheme to steal from only

by defendant because defendant had “no reasonable expectation” of being able to sell so much product).

361. See *United States v. Lorenzo*, 995 F.2d 1448, 1460 (9th Cir. 1993) (citing *United States v. Koenig*, 952 F.2d 267, 271-72 (9th Cir. 1991) (“[S]ection 2F1.1 only requires a calculation of ‘intended loss’ and does not require a finding that the intentions were realistic.”)). See also *United States v. Jacobs*, 117 F.3d 82, 94-98 (2d Cir. 1997) (upholding face amount of fraudulent bank drafts as loss despite very small risk that drafts would actually be honored); *United States v. Studevent*, 116 F.3d 1559, 1561-62 (D.C. Cir. 1997) (intended loss need not be realistically possible); *United States v. Ismoila*, 100 F.3d 380, 396 (5th Cir. 1996) (“The fact that the victims were not at risk for the charges above their credit limit is not dispositive.”); *United States v. Wai-Keung*, 115 F.3d 874, 877 (11th Cir. 1997) (same); *United States v. Coffman*, 94 F.3d 330, 336 (7th Cir. 1996) (expressly rejecting the argument “that a loss that cannot possibly occur cannot be intended”); *United States v. DeFelippis*, 950 F.2d 444 (7th Cir. 1991) (irrelevant that there was “no possibility” defendant would obtain loan based on fraudulent misrepresentations).

362. U.S.S.G. § 2B1.1, app. n.2(A)(ii) (2001).

363. *Id.* § 2B1.1(b)(4)(A) (2000), and § 2F1.1(b)(2)(A) (2000).

364. *Id.* § 2F1.1(b)(2)(B).

365. *Id.* § 2B1.1(b)(2) (2001). The new guideline also adds an enhancement for making false statements to a consumer in connection with educational loans. *Id.* § 2B1.1(b)(7)(D).

366. *Id.* § 2F1.1(b)(5) (1998).

one. However, the former theft and fraud guidelines accounted for these factors only through the "more than minimal planning" adjustment in both the fraud and theft guidelines, and the more-than-one-victim adjustment in the fraud guideline. Because the more than minimal planning enhancement was applied to more than eighty percent of all defendants sentenced under the fraud guideline and more than sixty percent of those sentenced under the theft guideline,<sup>367</sup> it did very little to differentiate the relative culpability of fraud and theft defendants. By setting the bar for the enhancement so low, the former guidelines made no distinction between the mental state of a small business owner who carried out a \$10,000 check kite and that of a fraudulent telemarketer who defrauded thousands of victims and concealed the proceeds in offshore bank accounts.

It was suggested that the Guidelines could better account for gradations in mental state by: abolishing the more than minimal planning adjustment; creating instead an enhancement for those defendants who really did engage in complex planning; creating a downward adjustment for only minimal planning or a single instance of impulsive behavior; and creating a new enhancement for multiple victims that imposed differing increases in offense level depending on the number of victims.<sup>368</sup> The Commission ultimately adopted three-fourths of this approach.

Effective November 1, 1998, the Commission added a two-level enhancement to the former fraud guideline applicable if "(A) the defendant relocated, or participated in relocating, a fraudulent scheme to another jurisdiction to evade law enforcement or regulatory officials; (B) a substantial part of a fraudulent scheme was committed from outside the United States; or (C) the offense otherwise involved sophisticated means."<sup>369</sup> This amendment was originally submitted to Congress in September 1998 as a temporary emergency amendment. In 2000, the Commission made the amendment permanent,<sup>370</sup> and renumbered it from Section 2F1.1(b)(5) to Section 2F1.1(b)(6).<sup>371</sup> It is now incorporated in the new economic crime guideline as Section 2B1.1(b)(8).

As noted, the new economic crime guideline eliminates more than minimal planning. The new economic crime guideline also contains a two-tiered enhancement for offenses involving numerous victims.<sup>372</sup> If the offense involved more than ten but fewer than fifty victims, the offense level increases by two.<sup>373</sup> Offenses involving fifty or more victims receive a four-level increase.<sup>374</sup> As yet, the Commission has provided no offense level discount for minimal planning or one-time impulsive behavior.

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367. See Bowman, *Coping With "Loss,"* *supra* note 103, at 499 n.186.

368. *Id.* at 497-502.

369. U.S.S.G. § 2F1.1(b)(5).

370. *Id.* app. C, amend. 595 (2000).

371. *Id.* app. C, amend. 596 (2000).

372. For a discussion of the rationale for such an enhancement, see Frank O. Bowman, III, *Coping With "Loss,"* *supra* note 103, at 500-02.

373. U.S.S.G. § 2B1.1(b)(2)(A)(i) (2001).

374. *Id.* § 2B1.1(b)(2)(B).



### *I. Departures*

1. *Upward Departures.*—The application notes to the consolidated economic crime guideline contain a revised list of encouraged upward departure factors.<sup>375</sup> Some of the revisions merely rephrase encouraged departure factors listed in the former theft and fraud guidelines without any apparent change in meaning. For example, Application Notes 15(A)(i) and 15(A)(ii) of Section 2B1.1 (2001) authorize a departure if a defendant's object in committing an economic crime was to cause a non-monetary harm or if, in committing an economic crime, the defendant caused or risked "substantial non-monetary harm." These provisions merely break into two paragraphs, and provide examples for, the two clauses of Application Note 11(a) of former Section 2F1.1. In some cases, the new phrasing of old departure factors may have substantive impact. For example, the former fraud guideline encouraged departure if "the offense involved the *knowing* endangerment of the solvency of one or more victims."<sup>376</sup> The new economic crime guideline retains this enhancement, but omits the requirement that it be "knowing." The effect is to provide an encouraged departure in any case in which the solvency of a victim was endangered by the offense, regardless of whether the defendant was aware of that possibility.

The new guideline omits three encouraged, but virtually never used, departures listed in former Section 2F1.1: the departure for making false statements "for the purpose of facilitating some other crime,"<sup>377</sup> the departure for "endanger[ing] national security or military readiness,"<sup>378</sup> and the departure for "caus[ing] a loss of confidence in an important institution."<sup>379</sup>

Finally, the new economic crime guideline adds one new encouraged departure factor of considerable importance. Application Note 15(A)(iv) provides for an upward departure where "[t]he offense created a risk of substantial loss beyond the loss determined for purposes of subsection (b)(1)."<sup>380</sup> The inclusion of *risk of loss* as a departure factor is important primarily as a limitation on the category of actual loss. Under the former fraud guideline, a number of courts included in actual loss harms that victims never actually suffered, but which were risked by the defendant's conduct. For example, some courts refused to credit defendants for collateral posted in loan fraud cases, citing a so-called "risk theory of loss" pursuant to which loss would include not only actual economic harm suffered, but also the value of economic interests placed at risk.<sup>381</sup> A similar line of thinking was at work in investment fraud cases in

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375. *Id.* § 2B1.1 n.15 (2001).

376. *Id.* § 2F1.1 n.11(f) (2000) (emphasis added).

377. *Id.* § 2F1.1 n.11(b).

378. *Id.* § 2F1.1 n.11(d).

379. *Id.* § 2F1.1 n.11(e).

380. *Id.* § 2B1.1 n.15(A)(iv) (2001).

381. See, e.g., *United States v. Najjor*, 255 F.3d 979, 985 (9th Cir. 2001).

which courts refused to grant credit against loss for amounts paid to victims as part of the scheme.<sup>382</sup> By negative implication, the risk of loss departure in the new economic crime guideline rejects a “risk theory of loss.” Under the new guideline, actual loss includes only actual loss. Unrealized losses risked by the offense are to be considered only for purposes of departure.

2. *Downward Departures.*—The new economic crime guideline contains only one ground for an encouraged downward departure. A downward departure “may be warranted” in cases “in which the offense level determined under this guideline substantially overstates the seriousness of the offense.”<sup>383</sup> This language differs from the analogous provision of the former fraud guideline in that the old language spoke only of the amount of the loss overstating the seriousness of the offense.<sup>384</sup> However, the revision appears to be primarily one of style rather than substance.

### *J. Ex Post Facto Considerations*

In any case covered by Section 2B1.1 (2001) in which the criminal conduct was completed prior to November 1, 2001, the sentencing court will be obliged to determine whether application of the new economic crime guideline will benefit or disadvantage the defendant by comparison with a sentence under the former theft or fraud guidelines. If the defendant would have received a lower sentence under the old guidelines, the Ex Post Facto Clause compels imposition of that lower sentence rather than the higher sentence under Section 2B1.1 (2001).<sup>385</sup> The Guidelines’ “one book rule,” mandates that “The Guidelines Manual in effect on a particular date shall be applied in its entirety.”<sup>386</sup> Therefore, in pre-November 1, 2001 cases, in order to make the before-and-after comparison required by the Ex Post Facto Clause, courts will often have to perform two complete sentencing calculations, one using the old rules in their entirety, and the another using the new rules in their entirety.

### *K. Changes in Money Laundering Guidelines*

The essential critique of the former money laundering guideline stemmed from two points. First, a defendant could be convicted of money laundering for using the ill-gotten proceeds of a broad spectrum of crimes to perform virtually any financial transaction involving a bank or similar institution. Second, the guidelines set very high base offense levels merely for being convicted of a money laundering offense, regardless of the seriousness of the underlying offense (although there were some modest differences) and largely irrespective of the amount of money laundered. That is, money laundering of any type produced a

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382. See, e.g., *United States v. Munoz*, 233 F.3d 1117, 1138 (9th Cir. 2000).

383. U.S.S.G. § 2B1.1 n.15(B) (2001).

384. *Id.* § 2F1.1 n.8(b) (2000).

385. See *Miller v. Florida*, 482 U.S. 423, 432-33 (1987).

386. U.S.S.G. § 1B1.11(b)(2) (2001).



base offense level of 20,<sup>387</sup> and convictions under three subsections of 18 U.S.C. § 1956(a) produced base offense levels of 23.<sup>388</sup> A base offense level of 23 translates, irrespective of any other factor, into a sentence of about four years.<sup>389</sup> When one added on enhancement for the amount of laundered money,<sup>390</sup> the sentences were higher still.

According to some critics, this combination of circumstances often penalized laundering money derived from crime more harshly than the underlying crime itself, and created an incentive for prosecutors to charge money laundering in otherwise unexceptional fraud cases in order to generate far higher sentences than would otherwise be available. After years of debate, the Commission included in the 2001 economic crime package a new money laundering guideline that ties money laundering penalties much more closely to the penalties for the underlying crime that generated the laundered funds.<sup>391</sup> The focus of this Article is economic crime, not money laundering, which is often associated with drug trafficking and other offenses. Consequently, the details of the new money laundering guideline will not be discussed here.

Nonetheless, the new money laundering provision is of considerable importance to economic crime sentencing because henceforth a money laundering sentence will no longer be automatically higher than a fraud sentence. At a minimum, both counsel and the court will have to calculate carefully the differentials, if any, before agreeing to pleas or sentencing defendants.

### CONCLUSION

I hope readers find the foregoing analysis useful. The project of passing an economic crime package has been ongoing since 1995, and has drawn on the energy and talents of hundreds of lawyers, judges, past and present Sentencing Commissioners, and members of the Commission staff. Although no law is perfect, I am hopeful (and cautiously confident) that the provisions of this package will both simplify economic crime sentencing and generate sentences that are at least incrementally more just than those imposed under the former guidelines.

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387. *Id.* § 2S1.1(a)(2) (2000).

388. *Id.* § 2S1.1(a)(1).

389. *Id.* § 5A (Sentencing Table).

390. *Id.* § 2S1.1(b)(2).

391. *Id.* § 2S1.1 (2001). For example, the new Section 2S1.1(a)(1) refers to the offense level of the underlying offense as one measure of the proper offense level for money laundering, and Section 2S1.1(a)(2) ties base offense level to amount laundered using the new fraud table, and imposes only a two-level "premium" for money laundering.

## Appendix A

### The New Consolidated Economic Crime Guideline, U.S.S.G. § 2B1.1 (Nov. 1, 2001), and Selected Application Notes

**§2B1.1. Larceny, Embezzlement, and Other Forms of Theft; Offenses Involving Stolen Property; Property Damage or Destruction; Fraud and Deceit; Forgery; Offenses Involving Altered or Counterfeit Instruments Other than Counterfeit Bearer Obligations of the United States**

(a) Base Offense Level: 6

(b) Specific Offense Characteristics

(1) If the loss exceeded \$5,000, increase the offense level as follows:

<u>Loss</u>	<u>(Apply the Greatest)</u>	<u>Increase in Level</u>
(A)	\$5,000 or less	no increase
(B)	More than \$5,000	add 2
(C)	More than \$10,000	add 4
(D)	More than \$30,000	add 6
(E)	More than \$70,000	add 8
(F)	More than \$120,000	add 10
(G)	More than \$200,000	add 12
(H)	More than \$400,000	add 14
(I)	More than \$1,000,000	add 16
(J)	More than \$2,500,000	add 18
(K)	More than \$7,000,000	add 20
(L)	More than \$20,000,000	add 22
(M)	More than \$50,000,000	add 24
(N)	More than \$100,000,000	add 26.

(2) (Apply the greater) If the offense

(A) (i) involved more than 10, but less than 50, victims; or (ii) was committed through mass-marketing, increase by 2 levels; or

(B) involved 50 or more victims, increase by 4 levels.

(3) If the offense involved a theft from the person of another, increase by 2 levels.



- (4) If the offense involved receiving stolen property, and the defendant was a person in the business of receiving and selling stolen property, increase by 2 levels.
- (5) If the offense involved misappropriation of a trade secret and the defendant knew or intended that the offense would benefit a foreign government, foreign instrumentality, or foreign agent, increase by 2 levels.
- (6) If the offense involved theft of, damage to, or destruction of, property from a national cemetery, increase by 2 levels.
- (7) If the offense involved (A) a misrepresentation that the defendant was acting on behalf of a charitable, educational, religious, or political organization, or a government agency; (B) a misrepresentation or other fraudulent action during the course of a bankruptcy proceeding; (C) a violation of any prior, specific judicial or administrative order, injunction, decree, or process not addressed elsewhere in the guidelines; or (D) a misrepresentation to a consumer in connection with obtaining, providing, or furnishing financial assistance for an institution of higher education, increase by 2 levels. If the resulting offense level is less than level 10, increase to level 10.
- (8) If (A) the defendant relocated, or participated in relocating, a fraudulent scheme to another jurisdiction to evade law enforcement or regulatory officials; (B) a substantial part of a fraudulent scheme was committed from outside the United States; or (C) the offense otherwise involved sophisticated means, increase by 2 levels. If the resulting offense level is less than level 12, increase to level 12.
- (9) If the offense involved (A) the possession or use of any device-making equipment; (B) the production or trafficking of any unauthorized access device or counterfeit access device; or (C)(i) the unauthorized transfer or use of any means of identification unlawfully to produce or obtain any other means of identification; or (ii) the possession of 5 or more means of identification that unlawfully were produced from, or obtained by the use of, another means of identification, increase by 2 levels. If the resulting offense level is less than level 12, increase to level 12.
- (10) If the offense involved an organized scheme to steal vehicles or vehicle parts, and the offense level is less than level 14, increase to level 14.

- (11) If the offense involved (A) the conscious or reckless risk of death or serious bodily injury; or (B) possession of a dangerous weapon (including a firearm) in connection with the offense, increase by 2 levels. If the resulting offense level is less than level 14, increase to level 14.
- (12) (Apply the greater) If
- (A) the defendant derived more than \$1,000,000 in gross receipts from one or more financial institutions as a result of the offense, increase by 2 levels; or
  - (B) the offense substantially jeopardized the safety and soundness of a financial institution, increase by 4 levels.

If the resulting offense level determined under subdivision (A) or (B) is less than level 24, increase to level 24.

(c) Cross References

- (1) If (A) a firearm, destructive device, explosive material, or controlled substance was taken, or the taking of any such item was an object of the offense; or (B) the stolen property received, transported, transferred, transmitted, or possessed was a firearm, destructive device, explosive material, or controlled substance, apply §2D1.1 (Unlawful Manufacturing, Importing, Exporting, or Trafficking (Including Possession with Intent to Commit These Offenses); Attempt or Conspiracy), §2D2.1 (Unlawful Possession; Attempt or Conspiracy), §2K1.3 (Unlawful Receipt, Possession, or Transportation of Explosive Materials; Prohibited Transactions Involving Explosive Materials), or §2K2.1 (Unlawful Receipt, Possession, or Transportation of Firearms or Ammunition; Prohibited Transactions Involving Firearms or Ammunition), as appropriate.
- (2) If the offense involved arson, or property damage by use of explosives, apply §2K1.4 (Arson; Property Damage by Use of Explosives), if the resulting offense level is greater than that determined above.
- (3) If (A) neither subdivision (1) nor (2) of this subsection applies; (B) the defendant was convicted under a statute proscribing false, fictitious, or fraudulent statements or representations generally (e.g., 18 U.S.C. § 1001, § 1341,



§ 1342, or § 1343); and (C) the conduct set forth in the count of conviction establishes an offense specifically covered by another guideline in Chapter Two (Offense Conduct), apply that other guideline.

(d) Special Instruction

- (1) If the defendant is convicted under 18 U.S.C. § 1030(a)(4) or (5), the minimum guideline sentence, notwithstanding any other adjustment, shall be six months' imprisonment.

Commentary  
[Selected provisions]

2. Loss Under Subsection (b)(1). This application note applies to the determination of loss under subsection (b)(1).
- (A) General Rule. Subject to the exclusions in subdivision (D), loss is the greater of actual loss or intended loss.
- (i) Actual Loss. "Actual loss" means the reasonably foreseeable pecuniary harm that resulted from the offense.
- (ii) Intended Loss. "Intended loss" (I) means the pecuniary harm that was intended to result from the offense; and (II) includes intended pecuniary harm that would have been impossible or unlikely to occur (e.g., as in a government sting operation, or an insurance fraud in which the claim exceeded the insured value).
- (iii) Pecuniary Harm. "Pecuniary harm" means harm that is monetary or that otherwise is readily measurable in money. Accordingly, pecuniary harm does not include emotional distress, harm to reputation, or other non-economic harm.
- (iv) Reasonably Foreseeable Pecuniary Harm. For purposes of this guideline, "reasonably foreseeable pecuniary harm" means pecuniary harm that the defendant knew or, under the circumstances, reasonably should have known, was a potential result of the offense.
- (v) Rules of Construction in Certain Cases. In the cases described in subdivisions (I) through (III), reasonably foreseeable pecuniary harm shall be considered to include the pecuniary harm specified for those cases as follows:
- (I) Product Substitution Cases. In the case of a product substitution offense, the reasonably foreseeable

pecuniary harm includes the reasonably foreseeable costs of making substitute transactions and handling or disposing of the product delivered, or of retrofitting the product so that it can be used for its intended purpose, and the reasonably foreseeable costs of rectifying the actual or potential disruption to the victim's business operations caused by the product substitution.

- (II) Procurement Fraud Cases. In the case of a procurement fraud, such as a fraud affecting a defense contract award, reasonably foreseeable pecuniary harm includes the reasonably foreseeable administrative costs to the government and other participants of repeating or correcting the procurement action affected, plus any increased costs to procure the product or service involved that was reasonably foreseeable.
  - (III) Protected Computer Cases. In the case of an offense involving unlawfully accessing, or exceeding authorized access to, a "protected computer" as defined in 18 U.S.C. § 1030(e)(2), actual loss includes the following pecuniary harm, regardless of whether such pecuniary harm was reasonably foreseeable: reasonable costs to the victim of conducting a damage assessment, and restoring the system and data to their condition prior to the offense, and any lost revenue due to interruption of service.
- (B) Gain. The court shall use the gain that resulted from the offense as an alternative measure of loss only if there is a loss but it reasonably cannot be determined.
- (C) Estimation of Loss. The court need only make a reasonable estimate of the loss. The sentencing judge is in a unique position to assess the evidence and estimate the loss based upon that evidence. For this reason, the court's loss determination is entitled to appropriate deference. See 18 U.S.C. § 3742(e) and (f).

The estimate of the loss shall be based on available information, taking into account, as appropriate and practicable under the circumstances, factors such as the following:

- (i) The fair market value of the property unlawfully taken or destroyed; or, if the fair market value is impracticable to



determine or inadequately measures the harm, the cost to the victim of replacing that property.

- (ii) The cost of repairs to damaged property.
- (iii) The approximate number of victims multiplied by the average loss to each victim.
- (iv) More general factors, such as the scope and duration of the offense and revenues generated by similar operations.

(D) Exclusions from Loss. Loss shall not include the following:

- (i) Interest of any kind, finance charges, late fees, penalties, amounts based on an agreed-upon return or rate of return, or other similar costs.
- (ii) Costs to the government of, and costs incurred by victims primarily to aid the government in, the prosecution and criminal investigation of an offense.

(E) Credits Against Loss. Loss shall be reduced by the following:

- (i) The money returned, and the fair market value of the property returned and the services rendered, by the defendant or other persons acting jointly with the defendant, to the victim before the offense was detected. The time of detection of the offense is the earlier of (I) the time the offense was discovered by a victim or government agency; or (II) the time the defendant knew or reasonably should have known that the offense was detected or about to be detected by a victim or government agency.
- (ii) In a case involving collateral pledged or otherwise provided by the defendant, the amount the victim has recovered at the time of sentencing from disposition of the collateral, or if the collateral has not been disposed of by that time, the fair market value of the collateral at the time of sentencing.

(F) Special Rules. Notwithstanding subdivision (A), the following special rules shall be used to assist in determining loss in the cases indicated:

- (i) Stolen or Counterfeit Credit Cards and Access Devices; Purloined Numbers and Codes. In a case involving any counterfeit access device or unauthorized access device, loss includes any unauthorized charges made with the counterfeit access device or unauthorized access device and shall be not

less than \$500 per access device. However, if the unauthorized access device is a means of telecommunications access that identifies a specific telecommunications instrument or telecommunications account (including an electronic serial number/mobile identification number (ESN/MIN) pair), and that means was only possessed, and not used, during the commission of the offense, loss shall be not less than \$100 per unused means. For purposes of this subdivision, "counterfeit access device" and "unauthorized access device" have the meaning given those terms in Application Note 7(A).

- (ii) Government Benefits. In a case involving government benefits (e.g., grants, loans, entitlement program payments), loss shall be considered to be not less than the value of the benefits obtained by unintended recipients or diverted to unintended uses, as the case may be. For example, if the defendant was the intended recipient of food stamps having a value of \$100 but fraudulently received food stamps having a value of \$150, loss is \$50.
- (iii) Davis-Bacon Act Violations. In a case involving a Davis-Bacon Act violation (i.e., a violation of 40 U.S.C. § 276a, criminally prosecuted under 18 U.S.C. § 1001), the value of the benefits shall be considered to be not less than the difference between the legally required wages and actual wages paid.
- (iv) Ponzi and Other Fraudulent Investment Schemes. In a case involving a fraudulent investment scheme, such as a Ponzi scheme, loss shall not be reduced by the money or the value of the property transferred to any individual investor in the scheme in excess of that investor's principal investment (i.e., the gain to an individual investor in the scheme shall not be used to offset the loss to another individual investor in the scheme).
- (v) Certain Other Unlawful Misrepresentation Schemes. In a case involving a scheme in which (I) services were fraudulently rendered to the victim by persons falsely posing as licensed professionals; (II) goods were falsely represented as approved by a governmental regulatory agency; or (III) goods for which regulatory approval by a government agency was required but not obtained, or was obtained by fraud, loss shall include the amount paid for the property, services or goods transferred, rendered, or misrepresented, with no credit provided for the value of those items or services.



- (vi) Value of Controlled Substances. In a case involving controlled substances, loss is the estimated street value of the controlled substances.

3. Victim and Mass-Marketing Enhancement under Subsection (b)(2).

(A) Definitions. For purposes of subsection (b)(2):

- (i) “Mass-marketing” means a plan, program, promotion, or campaign that is conducted through solicitation by telephone, mail, the Internet, or other means to induce a large number of persons to (I) purchase goods or services; (II) participate in a contest or sweepstakes; or (III) invest for financial profit. “Mass-marketing” includes, for example, a telemarketing campaign that solicits a large number of individuals to purchase fraudulent life insurance policies.
- (ii) “Victim” means (I) any person who sustained any part of the actual loss determined under subsection (b)(1); or (II) any individual who sustained bodily injury as a result of the offense. “Person” includes individuals, corporations, companies, associations, firms, partnerships, societies, and joint stock companies.

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6. Sophisticated Means Enhancement under Subsection (b)(8).

- (A) Definition of United States. For purposes of subsection (b)(8)(B), “United States” means each of the 50 states, the District of Columbia, the Commonwealth of Puerto Rico, the United States Virgin Islands, Guam, the Northern Mariana Islands, and American Samoa.
- (B) Sophisticated Means Enhancement. For purposes of subsection (b)(8)(C), “sophisticated means” means especially complex or especially intricate offense conduct pertaining to the execution or concealment of an offense. For example, in a telemarketing scheme, locating the main office of the scheme in one jurisdiction but locating soliciting operations in another jurisdiction ordinarily indicates sophisticated means. Conduct such as hiding assets or transactions, or both, through the use of fictitious entities, corporate shells, or offshore financial accounts also ordinarily indicates sophisticated means.
- (C) Non-Applicability of Enhancement. If the conduct that forms the basis for an enhancement under subsection (b)(8) is the only conduct

that forms the basis for an adjustment under §3C1.1, do not apply that adjustment under §3C1.1.

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15. Departure Considerations.

- (A) Upward Departure Considerations. There may be cases in which the offense level determined under this guideline substantially understates the seriousness of the offense. In such cases, an upward departure may be warranted. The following is a non-exhaustive list of factors that the court may consider in determining whether an upward departure is warranted:
- (i) A primary objective of the offense was an aggravating, non-monetary objective. For example, a primary objective of the offense was to inflict emotional harm.
  - (ii) The offense caused or risked substantial non-monetary harm. For example, the offense caused physical harm, psychological harm, or severe emotional trauma, or resulted in a substantial invasion of a privacy interest (through, for example, the theft of personal information such as medical, educational, or financial records).
  - (iii) The offense involved a substantial amount of interest of any kind, finance charges, late fees, penalties, amounts based on an agreed-upon return or rate of return, or other similar costs, not included in the determination of loss for purposes of subsection (b)(1).
  - (iv) The offense created a risk of substantial loss beyond the loss determined for purposes of subsection (b)(1).
  - (v) The offense endangered the solvency or financial security of one or more victims.
  - (vi) In a case involving stolen information from a “protected computer”, as defined in 18 U.S.C. § 1030(e)(2), the defendant sought the stolen information to further a broader criminal purpose.
  - (vii) In a case involving access devices or unlawfully produced or unlawfully obtained means of identification:
    - (I) The offense caused substantial harm to the victim’s reputation or credit record, or the victim suffered a



substantial inconvenience related to repairing the victim's reputation or a damaged credit record.

(II) An individual whose means of identification the defendant used to obtain unlawful means of identification is erroneously arrested or denied a job because an arrest record has been made in that individual's name.

(III) The defendant produced or obtained numerous means of identification with respect to one individual and essentially assumed that individual's identity.

(B) Downward Departure Consideration. There may be cases in which the offense level determined under this guideline substantially overstates the seriousness of the offense. In such cases, a downward departure may be warranted.

Background: This guideline covers offenses involving theft, stolen property, property damage or destruction, fraud, forgery, and counterfeiting (other than offenses involving altered or counterfeit bearer obligations of the United States). It also covers offenses involving altering or removing motor vehicle identification numbers, trafficking in automobiles or automobile parts with altered or obliterated identification numbers, odometer laws and regulations, obstructing correspondence, the falsification of documents or records relating to a benefit plan covered by the Employment Retirement Income Security Act, and the failure to maintain, or falsification of, documents required by the Labor Management Reporting and Disclosure Act.

Because federal fraud statutes often are broadly written, a single pattern of offense conduct usually can be prosecuted under several code sections, as a result of which the offense of conviction may be somewhat arbitrary. Furthermore, most fraud statutes cover a broad range of conduct with extreme variation in severity. The specific offense characteristics and cross references contained in this guideline are designed with these considerations in mind.

The Commission has determined that, ordinarily, the sentences of defendants convicted of federal offenses should reflect the nature and magnitude of the loss caused or intended by their crimes. Accordingly, along with other relevant factors under the guidelines, loss serves as a measure of the seriousness of the offense and the defendant's relative culpability and is a principal factor in determining the offense level under this guideline.

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## Appendix B

### Former Guidelines Provisions Defining “Loss”

#### From U.S.S.G. § 2B1.1 (Theft Offenses), Application Notes

2. “Loss” means the value of the property taken, damaged, or destroyed. Ordinarily, when property is taken or destroyed the loss is the fair market value of the particular property at issue. Where the market value is difficult to ascertain or inadequate to measure harm to the victim, the court may measure loss in some other way, such as reasonable replacement cost to the victim. Loss does not include the interest that could have been earned had the funds not been stolen. When property is damaged, the loss is the cost of repairs, not to exceed the loss had the property been destroyed. Examples: (1) In the case of a theft of a check or money order, the loss is the loss that would have occurred if the check or money order had been cashed. (2) In the case of a defendant apprehended taking a vehicle, the loss is the value of the vehicle even if the vehicle is recovered immediately.

Where the offense involved making a fraudulent loan or credit card application, or other unlawful conduct involving a loan or credit card, the loss is to be determined under the principles set forth in the Commentary to ‘2F1.1 (Fraud and Deceit).

In certain cases, an offense may involve a series of transactions without a corresponding increase in loss. For example, a defendant may embezzle \$5,000 from a bank and conceal this embezzlement by shifting this amount from one account to another in a series of nine transactions over a six-month period. In this example, the loss is \$5,000 (the amount taken), not \$45,000 (the sum of the nine transactions), because the additional transactions did not increase the actual or potential loss.

In stolen property offenses (receiving, transporting, transferring, transmitting, or possessing stolen property), the loss is the value of the stolen property determined as in a theft offense.

In an offense involving unlawfully accessing, or exceeding authorized access to, a “protected computer” as defined in 18 U.S.C. §1030(e)(2)(A) or (B), “loss” includes the reasonable cost to the victim of conducting a damage assessment, restoring the system and data to their condition prior to the offense, and any lost revenue due to interruption of service.

In the case of a partially completed offense (e.g., an offense involving a completed theft that is part of a larger, attempted theft), the offense level is to be determined in accordance with the provisions of ‘2X1.1 (Attempt, Solicitation, or Conspiracy) whether the conviction is for the substantive



offense, the inchoate offense (attempt, solicitation, or conspiracy), or both; see Application Note 4 in the Commentary to '2X1.1.

3. For the purposes of subsection (b)(1), the loss need not be determined with precision. The court need only make a reasonable estimate of the loss, given the available information. This estimate, for example, may be based upon the approximate number of victims and the average loss to each victim, or on more general factors such as the scope and duration of the offense.
4. The loss includes any unauthorized charges made with stolen credit cards, but in no event less than \$100 per card. See Commentary to ' 2X1.1 (Attempt, Solicitation, or Conspiracy) and 2F1.1 (Fraud and Deceit).
5. Controlled substances should be valued at their estimated street value.

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15. In cases where the loss determined under subsection (b)(1) does not fully capture the harmfulness of the conduct, an upward departure may be warranted. For example, the theft of personal information or writings (e.g., medical records, educational records, a diary) may involve a substantial invasion of a privacy interest that would not be addressed by the monetary loss provisions of subsection (b)(1).

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**Background:** The value of the property stolen plays an important role in determining sentences for theft and other offenses involving stolen property because it is an indicator of both the harm to the victim and the gain to the defendant. Because of the structure of the Sentencing Table (Chapter 5, Part A), subsection (b)(1) results in an overlapping range of enhancements based on the loss.

#### **From U.S.S.G. § 2F1.1 (Fraud Offenses), Application Notes**

8. Valuation of loss is discussed in the Commentary to §2B1.1 (Larceny, Embezzlement, and Other Forms of Theft). As in theft cases, loss is the value of the money, property, or services unlawfully taken; it does not, for example, include interest the victim could have earned on such funds had the offense not occurred. Consistent with the provisions of §2X1.1 (Attempt, Solicitation, or Conspiracy), if an intended loss that the defendant was attempting to inflict can be determined, this figure will be used if it is greater than the actual loss. Frequently, loss in a fraud case will be the same as in a theft case. For example, if the fraud consisted of selling or attempting to sell \$40,000 in worthless securities, or representing that a forged check for \$40,000 was genuine, the loss would be \$40,000.

There are, however, instances where additional factors are to be considered in determining the loss or intended loss:

(a) Fraud Involving Misrepresentation of the Value of an Item or Product Substitution

A fraud may involve the misrepresentation of the value of an item that does have some value (in contrast to an item that is worthless). Where, for example, a defendant fraudulently represents that stock is worth \$40,000 and the stock is worth only \$10,000, the loss is the amount by which the stock was overvalued (*i.e.*, \$30,000). In a case involving a misrepresentation concerning the quality of a consumer product, the loss is the difference between the amount paid by the victim for the product and the amount for which the victim could resell the product received.

(b) Fraudulent Loan Application and Contract Procurement Cases

In fraudulent loan application cases and contract procurement cases, the loss is the actual loss to the victim (or if the loss has not yet come about, the expected loss). For example, if a defendant fraudulently obtains a loan by misrepresenting the value of his assets, the loss is the amount of the loan not repaid at the time the offense is discovered, reduced by the amount the lending institution has recovered (or can expect to recover) from any assets pledged to secure the loan. However, where the intended loss is greater than the actual loss, the intended loss is to be used.

In some cases, the loss determined above may significantly understate or overstate the seriousness of the defendant's conduct. For example, where the defendant substantially understated his debts to obtain a loan, which he nevertheless repaid, the loss determined above (zero loss) will tend not to reflect adequately the risk of loss created by the defendant's conduct. Conversely, a defendant may understate his debts to a limited degree to obtain a loan (*e.g.*, to expand a grain export business), which he genuinely expected to repay and for which he would have qualified at a higher interest rate had he made truthful disclosure, but he is unable to repay the loan because of some unforeseen event (*e.g.*, an embargo imposed on grain exports) which would have caused a default in any event. In such a case, the loss determined above may overstate the seriousness of the defendant's conduct. Where the loss determined above significantly understates or overstates the seriousness of the defendant's conduct, an upward or downward departure may be warranted.



(c) Consequential Damages in Procurement Fraud and Product Substitution Cases

In contrast to other types of cases, loss in a procurement fraud or product substitution case includes not only direct damages, but also consequential damages that were reasonably foreseeable. For example, in a case involving a defense product substitution offense, the loss includes the government's reasonably foreseeable costs of making substitute transactions and handling or disposing of the product delivered or retrofitting the product so that it can be used for its intended purpose, plus the government's reasonably foreseeable cost of rectifying the actual or potential disruption to government operations caused by the product substitution. Similarly, in the case of fraud affecting a defense contract award, loss includes the reasonably foreseeable administrative cost to the government and other participants of repeating or correcting the procurement action affected, plus any increased cost to procure the product or service involved that was reasonably foreseeable. Inclusion of reasonably foreseeable consequential damages directly in the calculation of loss in procurement fraud and product substitution cases reflects that such damages frequently are substantial in such cases.

(d) Diversion of Government Program Benefits

In a case involving diversion of government program benefits, loss is the value of the benefits diverted from intended recipients or uses.

(e) Davis-Bacon Act Cases

In a case involving a Davis-Bacon Act violation (a violation of 40 U.S.C. § 276a, criminally prosecuted under 18 U.S.C. § 1001), the loss is the difference between the legally required and actual wages paid.

9. For the purposes of subsection (b)(1), the loss need not be determined with precision. The court need only make a reasonable estimate of the loss, given the available information. This estimate, for example, may be based on the approximate number of victims and an estimate of the average loss to each victim, or on more general factors, such as the nature and duration of the fraud and the revenues generated by similar operations. The offender's gain from committing the fraud is an alternative estimate that ordinarily will underestimate the loss.

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11. In cases in which the loss determined under subsection (b)(1) does not fully capture the harmfulness and seriousness of the conduct, an upward departure may be warranted. Examples may include the following:

- (a) a primary objective of the fraud was non-monetary; or the fraud caused or risked reasonably foreseeable, substantial non-monetary harm;
- (b) false statements were made for the purpose of facilitating some other crime;
- (c) the offense caused reasonably foreseeable, physical or psychological harm or severe emotional trauma;
- (d) the offense endangered national security or military readiness;
- (e) the offense caused a loss of confidence in an important institution;
- (f) the offense involved the knowing endangerment of the solvency of one or more victims.

In a few instances, the loss determined under subsection (b)(1) may overstate the seriousness of the offense. This may occur, for example, where a defendant attempted to negotiate an instrument that was so obviously fraudulent that no one would seriously consider honoring it. In such cases, a downward departure may be warranted.

12. Offenses involving fraudulent identification documents and access devices, in violation of 18 U.S.C. §§ 1028 and 1029, are also covered by this guideline. Where the primary purpose of the offense involved the unlawful production, transfer, possession, or use of identification documents for the purpose of violating, or assisting another to violate, the laws relating to naturalization, citizenship, or legal resident status, apply §2L2.1 or §2L2.2, as appropriate, rather than §2F1.1. In the case of an offense involving false identification documents or access devices, an upward departure may be warranted where the actual loss does not adequately reflect the seriousness of the conduct.

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Background: This guideline is designed to apply to a wide variety of fraud cases. The statutory maximum term of imprisonment for most such offenses is five years. The guideline does not link offense characteristics to specific code sections. Because federal fraud statutes are so broadly written, a single pattern of offense conduct usually can be prosecuted under several code sections, as a result of which the offense of conviction may be somewhat arbitrary. Furthermore, most fraud statutes cover a broad range of conduct with extreme variation in severity.



Empirical analyses of pre-guidelines practice showed that the most important factors that determined sentence length were the amount of loss and whether the offense was an isolated crime of opportunity or was sophisticated or repeated. Accordingly, although they are imperfect, these are the primary factors upon which the guideline has been based.





# SUBSIDIARITY AS A PRINCIPLE OF GOVERNANCE: BEYOND DEVOLUTION

ROBERT K. VISCHER\*

## INTRODUCTION

With the ascension of George W. Bush to the presidency comes the public emergence of the subsidiarity principle, a doctrine previously familiar primarily to Catholic social theorists and observers of the European Union. Fundamentally and explicitly intertwined with Bush's "compassionate conservative" vision, subsidiarity calls for social problems to be addressed from the bottom up, rather than from the top down. Literally meaning "to 'seat' ('sid') a service down ('sub') as close to the need for that service as is feasible,"<sup>1</sup> subsidiarity holds that where families, neighborhoods, churches, or community groups can effectively address a given problem, they should. Where they cannot, municipal or state governments should intervene. Only when the lower bodies prove ineffective should the federal government become involved.

Subsidiarity has assumed a decidedly conservative gloss in today's public policy debates. Clung to by those seeking to shrink federal government programs and largely ignored by those who oppose them, subsidiarity appears to have become the exclusive property of one side of the political spectrum. This Article contends that the strictly conservative portrayal of subsidiarity misconstrues the nature of the Catholic social theory from which the principle arises. The conservative perspective also overlooks the affirmative government functions essential to subsidiarity's faithful implementation. Part I of the Article provides an overview of subsidiarity's expanding influence on debates over the role of government and its increasingly frequent equation with the concept of devolution. Part II traces the Catholic roots of subsidiarity and shows how the principle's origins transcend today's conservative and liberal dichotomy. Part III addresses subsidiarity's applicability to real-world governance, first looking to its role in the European Union and then to its more subtle but pervasive function as a principle of American federalism. In Part IV, the Article outlines several conceptual limitations on subsidiarity's devolutionary impetus, as seen in particular areas of law where an active federal role is essential to furthering the principle's objectives. That these areas are not federal priorities under current notions of compassionate conservatism underscores the fundamental misconceptions surrounding subsidiarity as a principle of governance.

## I. SUBSIDIARITY AND DEVOLUTION

The link between compassionate conservatism and subsidiarity has been

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1. J. Bryan Hehir, *Catholic Social Teaching and the Challenge of the Future*, WOODSTOCK REP., June 1998, <http://www.georgetown.edu/centers/woodstock/report/rfea54a.htm>.

drawn repeatedly and explicitly by proponents of the former. John J. DiIulio Jr., appointed by President Bush to head the new White House Office of Faith-Based and Community Initiatives, has gone so far as to assert that “[m]orally, compassionate conservatism is ‘subsidiarity conservatism.’”<sup>2</sup> Longtime Bush adviser Marvin Olasky, whom Bush calls “compassionate conservatism’s leading thinker,”<sup>3</sup> contends that “we should emphasize what’s called ‘subsidiarity.’ That means always looking first to families to help their own, then to churches and other community organizations. If it is necessary to turn to government, go first to city, then to county, then to state and only then to federal offices. . . .”<sup>4</sup> Further, the principle is a centerpiece of Bush’s embrace of the work of Catholic neoconservatives like Richard John Neuhaus and Michael Novak,<sup>5</sup> and Bush supporters invoked subsidiarity explicitly during the campaign in urging Catholics to vote for him.<sup>6</sup> Even where unspoken, subsidiarity underlies many of Bush’s policy proposals. In his “Duty of Hope” campaign speech outlining the compassionate conservative vision, “the word ‘subsidiarity’ never passed Bush’s lips, [but the] speech reads like a blueprint for applied subsidiarity.”<sup>7</sup>

Subsidiarity’s influence on modern governance runs well beyond the 2000 American presidential campaign. It is a founding principle of the European Union and has been cited as a factor in the Eastern European freedom movements of the 1980s.<sup>8</sup> In the United States, subsidiarity underlies a wide variety of current legislative actions. “Subsidiarity conservatism” has been invoked by members of Congress who “have worked to codify such [an] approach into legislative policy, specifically as a means to end poverty,”<sup>9</sup> and has been relied

2. John J. DiIulio Jr., *Compassionate Conservatism—The Right Course, the Right Time*, ORLANDO SENTINEL, Sept. 26, 1999, at G5 (emphasis added); see also Richard Morin, *Leading with His Right: John DiIulio, Ready to Go to the Mat with a Faith-Based Approach to Crime*, WASH. POST, Feb. 26, 2001, at C1 (reporting that for DiIulio, “subsidiarity is ‘the meat on the bones of compassionate conservatism’”). DiIulio’s tenure was short-lived, as he resigned in August 2001. Dana Milbank, *DiIulio Resigns from Top “Faith-Based” Post*, WASH. POST, Aug. 18, 2001, at A4.

3. Robert Westbrook, *Dubya-ism*, 117 CHRISTIAN CENTURY 912, 912 (2000) (book review).

4. Marvin Olasky, *Let Them Eat Beans*, AUSTIN AM.-STATESMAN, Sept. 29, 2000, at A15.

5. See Franklin Foer, *Spin Doctrine*, NEW REPUBLIC, June 5, 2000, at 18; Andrew Sullivan, *Bush Woos Catholic Conservatives*, SUNDAY TIMES (London), June 25, 2000, at 4.

6. See William J. Bennett & Vin Weber, *The Catholic Case for George W. Bush: His Views on Society, Government and the Poor Are Fully in Accord with the Church’s Values*, PITTSBURGH POST-GAZETTE, Nov. 2, 2000, at A29.

7. DiIulio, *supra* note 2, at G1; see also Ryan Lizza, *Write Hand*, NEW REPUBLIC, May 21, 2001, at 14 (reporting that Michael Gerson, Bush’s chief speechwriter, “sees compassionate conservatism as a way to reconcile what he considers the two most vital conservative intellectual traditions: libertarianism and Catholic social thought”).

8. The ideal of subsidiarity, “being that the state is there to serve civil society, not to dominate over it,” has also been cited as lying at the heart of the freedom movement in Poland. Jean Bethke Elshtain, *Will the Real Civil Society Advocates Please Stand Up?*, 75 CHI.-KENT L. REV. 583 (2000).

9. Rick Santorum, *A Compassionate Conservative Agenda: Addressing Poverty for the Next*



on to justify the decentralization of environmental law,<sup>10</sup> opposition to campaign finance reform,<sup>11</sup> the privatization of urban land use regulations,<sup>12</sup> and even an initiative to provide broadcast licenses to low-power radio stations.<sup>13</sup> Subsidiarity is reflected, albeit implicitly, in the myriad federal statutes that “allow states to enact their own regulatory programs, provided they meet” minimum standards.<sup>14</sup> The principle has also been looked to as the model for interpreting Supreme Court jurisprudence, including decisions upholding parents’ authority over their children’s education<sup>15</sup> and limiting the Commerce Clause’s scope.<sup>16</sup>

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*Millennium*, 26 J. LEGIS. 93, 94 (2000) (discussing welfare reform and increased reliance on churches and charities).

10. See James L. Huffman, *The Past and Future of Environmental Law*, 30 ENVTL. L. 23, 31 (2000) (observing that in environmental matters, “[p]erhaps Americans are moving toward the regulatory philosophy of subsidiarity—the principle that the best government is that which is the least centralized yet still adequate to accomplish the task at hand”); Wallace E. Oates, *On Environmental Federalism*, 83 VA. L. REV. 1321, 1322 (1997) (arguing that opposition to decentralized environmental regulation “represents a fundamental inconsistency with the basic principle of subsidiarity to which the European Community has subscribed”).

11. See Jack B. Sarno, Note, *A Natural Law Defense of Buckley v. Valeo*, 66 FORDHAM L. REV. 2693, 2767 (1998) (“McCain-Feingold, with its flat prohibition of even modest contributions by PACs and its harsh restrictions on independent expenditures and issue advocacy, detracts from, rather than promotes, the principle of subsidiarity by diminishing the role that these (instrumental) associations play.”).

12. See Steven J. Eagle, *Privatizing Urban Land Use Regulation: The Problem of Consent*, 7 GEO. MASON L. REV. 905, 913-14 (1999) (discussing devolution of regulatory powers from planning boards and municipal legislatures to neighborhood groups).

13. See Kevin Clarke, *A Public Disservice Message*, U.S. CATHOLIC, Mar. 1, 2001, at 35 (calling congressional defeat of Federal Communications Commission initiative “an example of the principle of subsidiarity turned precisely inside out”).

14. George A. Bermann, *Taking Subsidiarity Seriously: Federalism in the European Community and the United States*, 94 COLUM. L. REV. 332, 414 (1994) (citing, inter alia, the Clean Water Act, the Occupational Safety and Health Act, and the Resource Conservation and Recovery Act).

15. In his article, *Taking Pierce Seriously: The Family, Religious Education, and Harm to Children*, 76 NOTRE DAME L. REV. 109 (2000), Richard Garnett argues:

Perhaps *Pierce* [*v. Society of Sisters of the Holy Names of Jesus & Mary*, 268 U.S. 510 (1925),] and the cluster of values and maxims for which it is thought to stand are best defended not in terms of parents’ individual “rights” against government, and certainly not in terms of ownership and property, but instead in terms of subsidiarity. Maybe we should think of the family, as it appears in *Pierce* and in contemporary debates about civic education, parental authority, and religious freedom, as the original “mediating institution.”

*Id.* at 144-45 (footnote omitted).

16. David P. Currie, *Subsidiarity*, 1 GREENBAG 2D 359, 363 (1998) (discussing *United States v. Lopez*, 514 U.S. 549 (1995)).

In all of this, subsidiarity is treated as a strictly devolutionary principle compelling the reallocation of social functions from higher to lower government bodies, or from government to non-government entities. Rarely, if ever, is subsidiarity looked to as warranting a greater role for the federal government in combating a given social problem. Frequently, subsidiarity is expressly equated with devolution.<sup>17</sup> Even where a broader definition is given, it invariably tracks devolutionary dogma.<sup>18</sup> Given the unrelenting portrayal of subsidiarity as a doctrine of privatization and decentralization, it is no wonder that the principle is now identified almost exclusively with the tenets of the Republican Party.<sup>19</sup>

In addition to the popular rhetoric, more scholarly efforts have also lent credibility to the notion that subsidiarity warrants broad decentralization of government authority. Douglas Kmiec portrays subsidiarity as a component of the Tenth Amendment, whereby the centralization or federalization of government functions is disfavored.<sup>20</sup> Stephen Gardbaum proposes a model of

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17. See, e.g., Marshall J. Breger, *Government Accountability in the Twenty-First Century*, 57 U. PITT. L. REV. 423, 430 (1996) ("The principle of devolution, often called subsidiarity in the European Union context, is based on the notion that decisions made closest to those affected are likely to be the best informed and certainly the most democratically based." (footnote omitted)); A. Michael Froomkin, *Of Governments and Governance*, 14 BERKELEY TECH. L. J. 617, 621 n.8 (1999) ("Subsidiarity is the devolution of responsibility to smaller political units in the context of a federal system.").

18. See, e.g., Robert A. Sirico, *Restoring Charity: Ethical Principles for a New Welfare Policy*, in *TRANSFORMING WELFARE: THE REVIVAL OF AMERICAN CHARITY* (Jeffrey J. Sikkenga ed., 1997), <http://wee.acton.org/publicat/books/transformwelfare/sirico.html> (invoking subsidiarity as the foundation for privatizing welfare, arguing that "[t]he only way out of this [welfare] mess is to return much of the responsibility for dealing with these problems [of poverty] back to its proper place: the private sector"); Foer, *supra* note 5, at 18 ("To reconcile their capitalist faith in self-interest with Catholicism's abnegation of self-interest, Neuhaus and Novak have not only highlighted subsidiarity, they have redefined Pius's concept of it—removing any statist inflection and making it a devolutionary doctrine."); Arthur F. McGovern, S.J., *Entitlements and Catholic Social Teachings*, 11 NOTRE DAME J.L. ETHICS & PUB. POL'Y 445, 450 (1997) (noting that while portions of 1931 papal encyclical *Quadragesimo anno* "suggest papal support of government assistance programs, the 'principle of subsidiarity' first promulgated in this encyclical has often served as an argument for severely limiting or even trying to avoid such programs"); Jean Schere, *Subsidiarity and Federalism in the European Union*, 24 FLETCHER F. WORLD AFF. 175, 181 (2000) ("Decentralization and competition are thus categorical imperatives for any federal arrangement if subsidiarity is to be preserved and extended as a guiding principle for the EU's modus operandi.").

19. See Joe Carroll, *Bush Campaign Targets Vital Catholic Votes to Succeed in Presidential Race*, IRISH TIMES, Oct. 21, 2000, at 13 ("Mr. Bush's insistence on taking power away from Washington and leaving the states to make more decisions also ties in with the Catholic concept of 'subsidiarity' whereby social problems are best dealt with at local or regional level rather than by a central bureaucracy."); Santorum, *supra* note 9, at 93 (portraying subsidiarity and compassionate conservatism as "manifest, in part, in the Republican Party tradition").

20. See Douglas W. Kmiec, *Liberty Misconceived: Hayek's Incomplete Relationship Between Natural and Customary Law*, 40 AM. J. JURIS. 209, 215 (1995).



constitutional federalism that, while textually based on the Necessary and Proper Clause, borrows from the subsidiarity principle in expressing “the idea that in areas of concurrent federal and state . . . competence, exercises of federal legislative power ought in some very general, but important, sense to be understood as exceptional or ‘subsidiary’ to regulation by the states and, therefore, to carry a special burden of justification.”<sup>21</sup> His model, along with the European Union’s express adoption of the subsidiarity principle,<sup>22</sup> “raise [the] presumption in favor of state regulatory competence to constitutional status in the sense that they deny to the federal entity complete and unreviewable legislative discretion to rebut it.”<sup>23</sup> If Kirk Kennedy is correct, subsidiarity’s devolutionary impetus may actually have gained constitutional standing through the jurisprudence of at least one Supreme Court justice.<sup>24</sup>

The equation of subsidiarity with devolution, at least in this country, originates primarily with neoconservatives like Novak and Neuhaus, who made subsidiarity one of the founding principles of their movement. Novak contends that in a welfare state, “the administrative state steadily swallows up most of the functions that used to be exercised by civil society . . . [and] [t]hus, the principle of subsidiarity is continually violated, as the higher levels crush the lower.”<sup>25</sup> Instead, according to Novak, “[w]hat the free world needs, rapidly, is a devolution of significant responsibilities from centralized bureaucracies to citizens, alone and in their multiple associations.”<sup>26</sup>

Given this background, one might conclude that subsidiarity was created as a component of the Republican or Libertarian party platforms, not as a Catholic principle of social justice. That is not to suggest that all conservative applications of subsidiarity are unfaithful to the principle’s origins or intended purpose. Certainly the intervention and expansion of government authority in many contexts runs counter to any reasonable reading of subsidiarity. But the devolutionary elements of subsidiarity are only half of the story. To engage the principle in its truest and fullest sense, one must engage the Catholic social theory from which it arises.

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21. Stephen Gardbaum, *Rethinking Constitutional Federalism*, 74 TEX. L. REV. 795, 833 (1996).

22. See *infra* notes 88-90 and accompanying text.

23. Gardbaum, *supra* note 21, at 833.

24. See Kirk A. Kennedy, *Reaffirming the Natural Law Jurisprudence of Justice Clarence Thomas*, 9 REGENT U. L. REV. 33, 82 (1997) (“In key cases addressing issues of federalism and the parameters of congressional power, [Justice] Thomas has consistently adhered to a position that mirrors the natural law doctrine of subsidiarity.”).

25. MICHAEL NOVAK, ON CULTIVATING LIBERTY 97 (Brian C. Anderson ed., 1999).

26. *Id.* at 106. Note that Novak acknowledges that some role for the federal government is still needed and that some aspects of the welfare state have been positive (e.g., care for the elderly). See *id.* at 99-100, 107.

## II. CATHOLIC SOCIAL THEORY AND SUBSIDIARITY

### A. *The Catholic Roots of Subsidiarity*

Subsidiarity is a uniquely Catholic principle that underlies much of the Church's teaching on social justice issues.<sup>27</sup> The fact that subsidiarity is now the subject of debate among Brussels bureaucrats and American presidential advisors does not render its religious origins less relevant. One reason is that the current invocations of subsidiarity intend to mirror the word's Catholic meaning.<sup>28</sup> Of course, nothing precludes today's policymakers and scholars from disconnecting subsidiarity from its traditional meaning grounded in Catholic social theory. Doing so, however, should entail, at a minimum, an explicit recognition of such a step, as well as a clear demarcation of the distinctions between the traditional and proposed meanings of the word. Given that these elements are absent from the work to date of any subsidiarity proponent, this Article assumes that current invocations of subsidiarity are at least intended to be consistent with the word's original meaning.

Second, the fact that its roots are in Catholicism does not make subsidiarity inaccessible to arguments of logic and public policy. While the relevant Church documents "make frequent references both to the natural law and to Scripture . . . increasingly the argument relies on eliciting judgments in response to narratives about social change and the broad outline of historical developments."<sup>29</sup> This grounding in non-theological sources "leaves the argument open for questions and criticisms from those who stand outside the faith community but who share the concerns of what have often been called 'social Catholics' for the common good of the entire society and the condition of the poorest."<sup>30</sup>

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27. William F. Buckley wrote that "[t]o call us subsidiarists anti-Catholic is about as convincing as calling the Popes anti-Catholic." PATRICK ALLITT, *CATHOLIC INTELLECTUALS AND CONSERVATIVE POLITICS IN AMERICA, 1950-1985*, at 91 (1993) (quoting William F. Buckley, Jr., *A Very Personal Answer to My Critics*, CATHOLIC WORLD, Mar. 1961, at 360, 365).

28. This intent is most apparent in compassionate conservatism's invocation of subsidiarity, see, e.g., Bennett & Weber, *supra* note 6, at A29, but also underlies—albeit more subtly—the applications of the principle in the European Union. See, e.g., M. Spieker, *The Actuality of Catholic Social Doctrine*, in *PRINCIPLES OF CATHOLIC SOCIAL TEACHING* 27 (David A. Boileau ed., 1998) (1994) [hereinafter CATHOLIC SOCIAL TEACHING] (noting that the language of European Union discussions of subsidiarity reflects the 1931 encyclical *Quadragesimo anno*).

29. John Langan, *The Catholic Vision of World Affairs*, 42 ORBIS 24, 252 (1998).

30. *Id.*; see also M.D. Litonjua, *Global Capitalism: The New Context of Christian Social Ethics*, 56 THEOLOGY TODAY 210 (1999) ("Since the Second Vatican Council, there has been a significant shift in the approach of Catholic documents and theology to social issues. This methodological shift has been away from a deductive, natural law approach in dealing with questions of social ethics to an inductive approach of social analysis and scriptural-theological reflection."); Spieker, *supra* note 28, at 27 ("One could make the objection that the demand for the subsidiarity principle is not a demand yet for Catholic social doctrine. The subsidiarity principle



Third, and most fundamentally, Catholicism provides more than an academic explanation of the word's origins; it also provides the historical and theological context that gives the word meaning. To invoke subsidiarity in public policy debates without acknowledging and exploring its Catholic roots is to cut off the principle from the particular priorities it reflects and the broader values it embodies.

Subsidiarity was created to describe a certain approach to the problems of modern society—an approach reflecting a broad understanding of human nature, government, and social structures. In his 1931 encyclical *Quadragesimo anno*, Pope Pius XI cast the principle as a fundamental tenet of Catholic social teaching in the following passage:

[I]t is a fundamental principle of social philosophy, fixed and unchangeable, that one should not withdraw from individuals and commit to the community what they can accomplish by their own enterprise and industry. So, too, it is an injustice and at the same time a grave evil and a disturbance of right order, to transfer to the larger and higher collectivity functions which can be performed and provided for by lesser and subordinate bodies. Inasmuch as every social activity should, by its very nature, prove a help to members of the body social, it should never destroy or absorb them.<sup>31</sup>

While *Quadragesimo anno* made subsidiarity explicit, its underlying message was by no means new to Catholic teachings. Traditionally,

[r]ather than drawing a sharp contrast between a private sphere of atomistic individuals and a public sphere controlled by the state, Catholic social theory cast society as a complex web of family, social, religious, and governmental ties with the ultimate goal of encouraging and empowering the individual exercise of responsibility.<sup>32</sup>

Subsidiarity perfectly embodied this notion that a society's health is a function, in great part, of the vibrancy and empowerment of individuals acting together

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is, of course, not an exclusive possession of Catholic social doctrine and is definitely not a doctrinal rule. It is an organization principle that is anthropologically founded and that can be made rationally insightful. This far, it is possible to be made understandably approachable also for non-Catholics and even for non-Christians and unbelievers.”). Further, that Catholic social theory does not rely exclusively on religious doctrine in its pursuit of the common good—especially in its vision of government, as reflected in concepts such as subsidiarity—precludes potential Establishment Clause objections to legislators’ reliance on subsidiarity, even where explicit. See *Lynch v. Donnelly*, 465 U.S. 668, 680 (1984) (“The Court has invalidated legislation or governmental action on the ground that a secular purpose was lacking, but only when it was concluded that there was no question that the statute or activity was motivated wholly by religious considerations.”).

31. Pius XI, *Quadragesimo anno* (1931), reprinted in SEVEN GREAT ENCYCLICALS 147, para. 79 (1963).

32. Paul D. Marquardt, *Subsidiarity and Sovereignty in the European Union*, 18 FORDHAM INT’L L.J. 616, 619 (1994).

through social groupings and associations.

By the time of *Libertatis Conscientia*—issued by the Church's Congregation for the Doctrine of Faith in 1986—subsidiarity was referred to, along with solidarity, as the fundamental principle of the Church's social doctrine. Whereas solidarity “refers to the social responsibility of humans and implies a rejection of individualism; [subsidiarity] refers to the responsibility of people and intermediary communities, and implies a rejection of collectivism.”<sup>33</sup> Today, even where subsidiarity is not the explicit foundation, its spirit underlies much of Catholic teaching. For example, the *Guidelines of the Congregation for the Catholic Education* suggest that “the demand for social justice is met through participation. The just, fitting, and responsible participation by all parts of the society in the development of social, political, economic, and cultural life is the most certain way to come to a new society.”<sup>34</sup>

There is no dispute that subsidiarity has been embraced—at least conceptually—by Catholic social theorists from both sides of the political spectrum. The grounds for dispute do not concern the principle's appeal, but its real-world implementation. Compassionate conservatives have politicized subsidiarity by circumscribing the breadth of its application and elevating devolution as its sole operating guideline. Catholic teachings do not provide a detailed blueprint of subsidiarity's applicability in every circumstance of modern governance. They do, however, show that compassionate conservatives have glossed over inescapable truths about subsidiarity that detract from their political agenda. While there are certainly devolutionary aspects to an honest interpretation of the principle, subsidiarity also stands for individual empowerment, and it compels the government to play a significant role in fostering the conditions necessary for its implementation.

### B. Catholic Social Theory and Limited Government

Mining Catholic teachings for political truths is a risky business. While the Catholic Church has long embraced certain fixed truths about society, its problems, and paths of progress, no political regime, movement, or party can claim to be the Church's standard bearer on matters of public governance. As Pope John Paul II articulated in his 1987 encyclical *Sollicitudo rei socialis*, “[t]he church does not propose economic and political systems or programs nor does she show preference for one or the other, provided that human dignity is properly respected and promoted, and provided she herself is allowed the room she needs to exercise her ministry in the world.”<sup>35</sup> In that regard, “[w]hen articulating a vision of justice and suggesting the means to that end, the Catholic

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33. J. Verstraeten, *Solidarity and Subsidiarity*, in CATHOLIC SOCIAL TEACHING, *supra* note 28, at 133.

34. E. De Jonghe, *Participation in Historical Perspective*, in CATHOLIC SOCIAL TEACHING, *supra* note 28, at 149.

35. Lucia Ann Silecchia, *On Doing Justice & Walking Humbly with God: Catholic Social Thought on Law as a Tool for Building Justice*, 46 CATH. U. L. REV. 1163, 1173-74 (1997).



vision does not link itself with any political system or regime.”<sup>36</sup>

Of course, that has not stopped actors from both sides of the political spectrum from clothing themselves with Catholic doctrine and papal pronouncements in hopes of lending legitimacy to their agendas. The current advocates of subsidiarity generally seek out Catholic teachings echoing their own skepticism toward government authority. Although the strand of conservatism exalting the idea of market governance with no government intervention is plainly incompatible with Catholic teaching,<sup>37</sup> there are indeed plenty of sources in the Catholic tradition that appear to favor the free market over centralized government when it comes to solving society’s problems.

The Catholic Church has traditionally valued a private sphere of individual sovereignty, albeit circumscribed by some level of government authority. For example, the value placed by the Church on private property was evident as far back as the Thirteenth Century, when St. Thomas Aquinas “establishe[d] that people work more diligently and treat economic goods more carefully, when these goods, as well as the means of production, belong to themselves and are their personal property.”<sup>38</sup>

Subsidiarity, however, is a relatively recent creation, and thus the last century of Catholic social theory is the most relevant to our inquiry. Before judging the political tenor of subsidiarity’s origins, the wider historical context of those origins must be acknowledged. In this regard, much of the skepticism toward government expressed in Twentieth Century Catholic teachings can be best understood as a reaction against Marxism more than a reaction against the modern democratic state.<sup>39</sup> According to Richard De George, the papal encyclicals *Rerum novarum*, *Quadragesimo anno*, *Mater et magistra*, *Laborem exercens*, and *Centesimus annus* should all be viewed in this light.<sup>40</sup>

36. *Id.* at 1173.

37. Litonjua, *supra* note 30, at 214 (“The unfettered market ideology is the new fundamentalism sweeping across the one world in the making, commodifying and commercializing human life and everything it touches—without moral moorings, without human values and considerations, without humane intentions and aspirations.”).

38. Rauscher, *Institutions of Social Organization: Family, Private Property, State*, in CATHOLIC SOCIAL TEACHING, *supra* note 28, at 71, 80.

39. See Richard T. De George, *Neither the Hammer and Sickle nor the Eye of the Needle: One Hundred Years of Catholic Social Thought on Economic Systems*, in CATHOLIC SOCIAL THOUGHT AND THE NEW WORLD ORDER 127, 127-28 (Oliver F. Williams & John W. Houck eds., 1993) [hereinafter NEW WORLD ORDER].

40. *Id.* at 130. This historical context also influenced many of American Catholicism’s expressions regarding capitalism. In terms more explicit than those used in the papal encyclicals, American Catholic leaders publicly defended capitalism in the wake of Marxism’s rise. Whether the defenses were driven more by the market’s merits or by Marxism’s dangers may be a matter of dispute. In any event, the most prominent Church leaders in this country—including Cardinal Joseph Mundelein of Chicago and Cardinal Francis Spellman of New York—went on the record touting capitalism’s virtues. See ALLITT, *supra* note 27, at 71. It was against this background that William F. Buckley, Jr. made capitalism a public cause of Catholic intellectuals in his 1950s books

The anti-Marxist writings of Pope John Paul II have provided by far the most fertile ground for those looking to conclude that the Church has become skeptical of centralized government. Some have gone so far as to connect his teachings with compassionate conservatism.<sup>41</sup> John Paul II is generally viewed as espousing a more conservative social theory than that of his predecessors, especially in his encyclical *Centesimus annus*, in which he argues that

[b]y intervening directly and depriving society of its responsibility, the Social Assistance State leads to a loss of human energies and an inordinate increase of public agencies, which are dominated more by bureaucratic ways of thinking than by concern for serving their clients, and which are accompanied by an enormous increase in spending.<sup>42</sup>

The significance of such statements was not lost on Vatican observers, for “although heretofore economic self-interest was equated largely with greed in church teaching, *Centesimus Annus* explicitly recognizes the virtues of a market economy in harnessing self-interest for the material betterment of society.”<sup>43</sup>

The conservative interpretation of John Paul II’s teachings must be tempered by the significant qualifications with which he affirms the value of a market economy. In the same encyclical that serves as the linchpin of the devolutionary view of government ascribed to him, John Paul II clearly contemplates a vital and active government. In answering whether he endorses capitalism, he includes a warning:

If by “capitalism” is meant an economic system which recognizes the fundamental and positive role of business, the market, private property, and the resulting responsibility for the means of production, as well as free human creativity in the economic sector, then the answer is certainly in the affirmative, even though it would perhaps be more appropriate to speak of a “business economy,” “market economy,” or simply “free economy.” But if by “capitalism” is meant a system in which freedom in the economic sector is not circumscribed within a strong juridical

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GOD AND MAN AT YALE (1951), and UP FROM LIBERALISM (1959). See *id.* at 73. “Buckley . . . wrote in favor of the free-market economy not in the abstract but as part of a protest against the increasing reach of the state and what he perceived as the overbearing power of trade unions.” *Id.*

41. See, e.g., Damon Linker, *John Paul II, Intellectual*, POL’Y REV., Oct./Nov. 2000, at 3 (“On closer inspection, then, John Paul’s political proposals arguably place him closer to the ‘compassionate conservatism’ of Marvin Olasky than to the bureaucratic paternalism of Eurosocialism.”).

42. John Paul II, *Centesimus annus* para. 48 (1991).

43. Oliver F. Williams, *Catholic Social Teaching: A Communitarian Democratic Capitalism for the New World Order*, in NEW WORLD ORDER, *supra* note 39, at 5, 11; see also Langan, *supra* note 29, at 250 (“[C]ontemporary Catholic social teaching, especially in the teaching of John Paul II, now offers a more vigorous and explicit endorsement of the market economy and of capitalist institutions and a greater stress on the importance of economic initiative as contrasted with wider eligibility for the provision by the government of economic benefits.”).



framework which places it at the service of human freedom in its totality, and which sees it as a particular aspect of that freedom, the core of which is ethical and religious, then the reply is certainly negative.<sup>44</sup>

In urging their own devolutionary glosses onto papal teachings, conservative critics downplay the import of passages to the extent that they stray from conservative principles. For example, Michael Novak objects to *Quadragesimo anno*'s mention of the need for a "directing principle" in economic life, based, in part, on his contention that "even [market] interventions made with the best of intentions defeat their own purposes, and there is no guarantee that actual interventions will even be well intended."<sup>45</sup> More confrontationally, Novak dismisses *Quadragesimo anno* because although it "speaks well of capitalism, and quite strongly of the importance of private property, it is plain that [Pope Pius XI] has not thoroughly considered the ways in which liberty, particularly in economic matters, is necessary to social justice and the best available servant of the common good."<sup>46</sup> Even John Paul II's recognition that government bureaucracies can have a detrimental effect on human conduct draws conservative fire. Damon Linker objects that the Pope "nonetheless hesitates to draw the right public policy implications from his insight: that the best of intentions can produce social pathologies in the poor that can only be remedied by refusing to coddle them."<sup>47</sup>

Despite detractors' criticism, there is an unmistakable call for government intervention throughout Catholic social theory. While the Church's teachings admittedly place limits on such intervention, those limits in no way eviscerate the core government functions contemplated. To focus exclusively on the Church's pro-market statements tells only half of the story and precludes a full and accurate debate on the public policy implications of many Catholic social teachings, including subsidiarity.

### C. Catholic Social Theory and Active Government

The role of government is so strong in traditional Catholic teachings that, in some circles, even a straightforward endorsement of capitalism is not without controversy.<sup>48</sup> This may be explained, at least in part, by the fact that Catholic social theory developed its theses in response to the liberalism of John Locke, by which "society is understood as a collection of individuals who have come

44. John Paul II, *supra* note 42, para. 42.

45. Michael Novak, *Liberty and Social Justice: Rescuing a Virtue*, in *NEW WORLD ORDER*, *supra* note 39, at 269, 276.

46. *Id.* at 273-74.

47. Linker, *supra* note 41, at 3.

48. Paul E. Sigmund, *Catholicism and Liberal Democracy*, in *NEW WORLD ORDER*, *supra* note 39, at 51, 69 ("Michael Novak and others have tried to make a stronger religious argument for the virtues of capitalism, but there remains in the Catholic tradition a belief that capitalism is based on greed and exploitation, and suspect from a moral point of view so that it requires state action to limit its excesses.").

together to promote and protect their private rights and interests."<sup>49</sup> Catholic social theory, by contrast, emphasizes the good of the community, not just the rights of individuals. For example, Catholicism has

always insisted that private property has a social dimension which requires that owners consider the common good in the use of property. This vision of society assumes that some persons will have more material goods than others but that the affluent will provide for the less fortunate, either through the channels of public policy or other appropriate groups of society.<sup>50</sup>

Given the nature of the common good espoused by the Church, some type of government role in pursuit of that good is inevitable. According to the 1992 *Catechism of the Catholic Church*, the common good has three essential elements: 1) "respect for the person"; 2) "the social well-being and the development of the group itself"; and 3) "peace[—]the security and permanence of a just order."<sup>51</sup> Pursuant to the second element, "[t]he authoritative bodies must make it possible that everyone gets access to everything that they need to lead a humane existence: food, clothes, health, work, education and culture, sufficient information, the right and the possibility to start a family, etc."<sup>52</sup>

An emphasis on the common good underlies all modern papal teachings, and government is at the front and center of the Church's real-world strategies for realizing the common good. Pope Leo XIII's 1891 *Rerum novarum*—the first modern papal pronouncement of Catholic social theory—taught "that the government of a political community had both the authority and the responsibility to promote the common good, the good of the community."<sup>53</sup> This "meant that the government had the right and the duty to intervene in the economic sphere in order to foster justice between capital and labor."<sup>54</sup> The government role contemplated in many of the teachings went far beyond anything reflected in the political reality of the time. Leo XIII gave "speeches about just wages, property, the freedom of unionization among workers, the role of the state, and the necessary simultaneity of changes in structure and mentality."<sup>55</sup> These speeches "were in part revolutionary and have not amounted to anything of actuality in many regions of the world."<sup>56</sup>

Even the primary sources of today's "conservative" Catholic social theory are far from dismissive of a government role when it comes to securing the common good. As noted above, John Paul II, in *Centesimus annus*, called "for

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49. Williams, *supra* note 43, at 5-6.

50. *Id.* at 11 (endnote omitted).

51. See De Jonghe, *supra* note 34, at 126-27 (emphasis omitted).

52. *Id.* at 126.

53. Fred Crosson, *Catholic Social Teaching and American Society*, in CATHOLIC SOCIAL TEACHING, *supra* note 28, at 165, 169.

54. *Id.*

55. Spieker, *supra* note 28, at 29.

56. *Id.*



a market economy protected by the state and flanked by a system of social obligations.”<sup>57</sup> In light of his teachings, “[i]t is clear . . . that John Paul II would not contemplate with approval any massive dismantling of the guarantees of the welfare state in Europe or elsewhere.”<sup>58</sup> And Novak acknowledges that the market is a “limited instrument,” that those who cannot fend for themselves need special care, and that other “social purposes [are] better met by other social mechanisms than the free market.”<sup>59</sup> He goes so far as to recognize that “[s]ome version of the welfare state (no doubt much reformed) is necessary for the stability and legitimacy of the free society, but also for its moral self-respect.”<sup>60</sup>

Catholic social theory cannot reasonably be read to suggest that the common good can be furthered only through government action, or even that government action has a direct correlation with the common good. Catholic social theory—at least in its more responsible forms—reflects a clear preference for capitalism over its primary Twentieth Century competitor, Communism. However, the public policy lessons to be drawn for established capitalist systems lie not so much in this general preference, but in the qualifications accompanying it. The key insight of modern Catholic social theory “is that capitalism without a context in a humane community seems inevitably to shape people into greedy and insensitive human beings.”<sup>61</sup> As a consequence, “the church teaching accepts the market economy but with a key qualification, that the state intervene where essential to promote and protect the human dignity.”<sup>62</sup> The crux of the debate is not determining whether state intervention is ever permissible, but determining when it is necessary. While reasonable minds differ as to the precise contours of the line between government and market-based solutions to social problems, any resolution based on Catholic social theory will necessarily be informed by the subsidiarity principle.

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57. *Id.* at 34. Some observers have noted the seemingly conflicting strands in *Centesimus annus*, as John Paul II expresses skepticism toward centralized government while embracing it as a check on the market. See, e.g., Williams, *supra* note 43, at 7 (“In one sense, *Centesimus Annus* wants to have it both ways: economic efficiency with all the advances it enables in the moral, social and political worlds, as well as a humane community insulated by government and private-sector intervention from the suffering entailed with a free economy’s creative destruction.”); *id.* at 15 (contending that in reading *Centesimus annus* both Democrats and Republicans “can find statements that seem to support their ideology”). In the end, however, “[t]he pope’s use of antithetical affirmations may be defensible,” as “[u]ltimately it may be better for the leader of a global church to highlight general themes, instead of prematurely closing debate or employing a cultural framework that is too narrow.” Daniel R. Finn, *John Paul II and the Moral Ecology of Markets*, 59 THEOLOGICAL STUD. 662, 664 (1998).

58. Langan, *supra* note 29, at 251.

59. Novak, *supra* note 45, at 279-80.

60. *Id.* at 282.

61. Williams, *supra* note 43, at 18.

62. *Id.*

#### D. Subsidiarity and Mediating Structures

Subsidiarity is not a knee-jerk shunning of government authority and embrace of any non-government entity, nor does it stand for the blanket devolution of government functions from the federal to the state level. Rather, subsidiarity is a principled tendency toward solving problems at the local level and empowering individuals, families and voluntary associations to act more efficaciously in their own lives. In this regard, the focus is on fostering the vitality of mediating structures in society.

Richard John Neuhaus and Peter Berger, who coined the term in the 1970s, define mediating structures as “*those institutions standing between the individual in his private life and the large institutions of public life.*”<sup>63</sup> The large institutions, or “megastructures,” include the state, as well as “the large economic conglomerates of capitalist enterprise, big labor, and the growing bureaucracies that administer wide sectors of the society, such as in education and the organized professions.”<sup>64</sup> What Neuhaus and Berger refer to as “private life” is the “curious kind of preserve left over by the large institutions and in which individuals carry on a bewildering variety of activities with only fragile institutional support.”<sup>65</sup>

The dilemma of modern life stems from the interplay between the public sphere—in which megastructures hold sway—and the private sphere—in which individuals conduct themselves freely. The dichotomy between the two spheres is stark, as “megastructures are typically alienating, that is, they are not helpful in providing meaning and identity for individual existence,” while “[m]eaning, fulfillment, and personal identity are to be realized in the private sphere.”<sup>66</sup> According to Neuhaus and Berger, this private/public split

poses a double crisis. It is a crisis for the individual who must carry on a balancing act between the demands of the two spheres. It is a political crisis because the megastructures (notably the state) come to be devoid of personal meaning and are therefore viewed as unreal or even malignant. Not everyone experiences crisis in the same way. Many who handle it more successfully than most have access to institutions that *mediate* between the two spheres. Such institutions have a private face, giving private life a measure of stability, and they have a public face, transferring meaning and value to the megastructures. Thus, mediating structures alleviate each facet of the double crisis of modern society.

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63. Richard John Neuhaus & Peter Berger, from *To Empower People: The Role of Mediating Structures in Public Policy* [hereinafter Neuhaus & Berger, *Mediating Structures*], in THE ESSENTIAL NEOCONSERVATIVE READER 213, 214 (Mark Gerson ed., 1996); see also Peter L. Berger & Richard John Neuhaus, *Peter Berger and Richard John Neuhaus Respond* [hereinafter Berger & Neuhaus, *Respond*], in TO EMPOWER PEOPLE: FROM STATE TO CIVIL SOCIETY 145, 148-49 (Michael Novak ed., 2d. ed., 1996) [hereinafter TO EMPOWER PEOPLE].

64. Neuhaus & Berger, *Mediating Structures*, *supra* note 63, at 214.

65. *Id.*

66. *Id.* at 214-15.



Their strategic position derives from their reducing both the anomic precariousness of individual existence in isolation from society and the threat of alienation to the public order.<sup>67</sup>

The mediating status of a group or institution stems not from any particular organizational identity, but from their tendency to facilitate self-empowerment and foster a sense of belonging and civic purpose. Neuhaus and Berger's call for mediating structures—a call that has since been echoed by many scholars<sup>68</sup>—focused on neighborhoods, families, churches, and voluntary associations.<sup>69</sup> When properly functioning, these institutions connect individuals to the wider society in ways that heighten their social awareness and maximize the impact of their actions, yet preserve their own unique sphere of operation and identity. From a subsidiarity perspective, these attributes are invaluable because they instill a sense of responsibility for one's self and one's surroundings, along with the tools needed to act in betterment of both.

Underlying the current portrayal of subsidiarity in public policy debates is a fundamental misunderstanding of the nature of mediating structures. Neuhaus and Berger acknowledged as much in reflecting on the widespread use of the term years after they originated it:

On the Left, the concept was understood in terms of grass-roots mobilization and, more recently, in communitarian terms. To be sure, some grass-roots organizations and local communities might indeed be mediating structures. But they might not be, either being invasions of people's life worlds by agents from the outside, in which case they are simply branches of mega-institutions, or being enclaves of private meanings and lifestyles with no relation to the larger society. On the Right, the concept was understood as including all institutions outside government, which, of course, stretches the concept beyond any usefulness. Neither General Motors nor the United Methodist Church is a mediating structure, though a workshop within a GM plant might be, as might a local Methodist congregation. As a matter of fact, even a local government agency might have a meaningful relationship with the values of the people it serves. Not every nongovernmental organization is a mediating structure.<sup>70</sup>

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67. *Id.* at 215.

68. See, e.g., Timothy L. Fort, *The First Man and the Company Man: The Common Good, Transcendence, and Mediating Institutions*, 36 AM. BUS. L.J. 391, 395 (1999) (contending that mediating institutions “teach moral norms because they socialize individuals to see that their self-interest is connected with the welfare of others”); W. Cole Durham, Jr. & Alexander Dushku, *Traditionalism, Secularism, and the Transformative Dimensions of Religious Institutions*, 1993 BYU L. REV. 421, 463 (calling for society to “grant space and relevance to religious mediating structures” in order to facilitate citizens moving between highly secular and highly religious environments).

69. See Neuhaus & Berger, *Mediating Structures*, *supra* note 63, at 215.

70. Berger & Neuhaus, *Respond*, *supra* note 63, at 149.

To qualify as a true mediating structure, an entity needs more than the absence of government influence. While mediating structures do function as bulwarks against government encroachment, they are also facilitators of individual empowerment and efficacy. The latter aspect stems from the frequently overlooked second half of subsidiarity's meaning. The principle first "refers, in a negative sense, to the restriction of intervention by the state."<sup>71</sup> As such, it expresses "a principle of non-interference of the state in the rights of the individual or of the higher or more encompassing communities in the activities in the smaller communities, namely where the individual or the small community is capable to fulfill its tasks itself."<sup>72</sup> The second component of subsidiarity refers "to the help which the individual of the small community may expect from the larger community, but only when it is no longer capable of fulfilling its tasks itself."<sup>73</sup> Under a slightly different reading, this positive aspect of subsidiarity expresses "a duty of the community to be helpful to its members in the fullest sense of the word, namely to give them the possibility to develop themselves to the fullest as people."<sup>74</sup>

This dual negative/positive meaning—imposing both limitations and affirmative duties on the government—is apparent in the Church's teachings on subsidiarity. Although *Quadragesimo anno* emphasizes subsidiarity's negative aspect, its portrayal shows that "[t]he narrow interweaving of the subsidiarity principle with justice must give free room for the state to act, as well as for smaller social units to actualize justice."<sup>75</sup> Pope John XXIII emphasizes the positive aspect in *Mater et magistra* as "[h]e pleads for a state intervention in different concrete areas," including "the obtaining of state property, the receiving of taxes, the granting of credit facilities, the supporting of social security, [and] price regulation."<sup>76</sup> Pope John Paul II returns to the negative aspect in *Sollicitudo rei socialis* and *Centesimus annus*, as his own encounters with socialism underscored the danger of "a slavish dependence of the (state) bureaucracy that is as faulty as the traditional dependence of the workers-proletarians on the nineteenth-century capitalism."<sup>77</sup> A more integrative tact was taken by United States bishops in their 1986 pastoral letter, *Economic Justice For All*, which is referred to by Dennis McCann as "[t]he most illuminating commentary on the operative meaning of the principle of subsidiarity."<sup>78</sup> In discussing the principle, the bishops' focus "shifts from limiting government intervention to identifying

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71. Verstraeten, *supra* note 33, at 135.

72. *Id.*

73. *Id.*

74. *Id.*

75. B. Kettern, *Social Justice: The Development of the Concept "iustitia" from St. Thomas Aquinas through the Social Encyclicals*, in CATHOLIC SOCIAL TEACHING, *supra* note 28, at 85, 93.

76. Verstraeten, *supra* note 33, at 136.

77. *Id.* at 145.

78. Dennis P. McCann, *Toward a Theology of the Corporation*, in NEW WORLD ORDER, *supra* note 39, at 329, 343.



and nurturing the range of private, professional, and quasi-governmental associations capable of entering into non-adversarial patterns of collaboration with government.”<sup>79</sup>

Under the positive aspect of subsidiarity, the government has an obligation to ensure the efficacy of mediating structures and the ability of individuals to take responsibility for themselves and their surroundings. It is this aspect that needs to be rejuvenated in today’s public policy debates. Subsidiarity not only calls for social institutions to act as bulwarks against government erosion of the private sphere, but also for the government itself to guard against the free market’s own tendency to erode those social institutions,<sup>80</sup> as well as to empower individuals and groups that have been marginalized by the market’s operation.<sup>81</sup> Fred Crosson’s formulation of subsidiarity reflects a balanced view of its dual aspects; it places proper emphasis on the need for government intervention without eviscerating the real limitations on such intervention:

The principle underlying subsidiarity thus stated is that a society is more just and more functional if the work that *can* be done by the parts *is* done by the parts, rather than being taken over by the whole. The responsibility of the state in this sphere is to assist the subsidiary groups in achieving their proper ends, and to implement those ends itself only temporarily in circumstances where the subsidiary group is, perhaps because of particular socio-economic conditions, incapable of functioning normally. This second aspect of subsidiarity involves the state intervening—but temporarily and in limited fashion—to secure the goods of the partial community, but only so long as the partial community is incapable of achieving its ends. Hence the state’s intervention should aim at helping the subsidiary group regain the capacity to function for itself.<sup>82</sup>

Given the central role of mediating structures under Crosson’s interpretation of subsidiarity, determining whether a particular policy will further subsidiarity’s objectives must include a recognition of the policy’s impact on those structures. Devolution for the sake of devolution cannot be justified as furthering subsidiarity. For example, while the devolution of federal welfare

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79. *Id.*

80. See Williams, *supra* note 43, at 19-20 (“Institutions such as the family, the church, the neighborhood and school are eroded when the market dominates life in society.”); cf. McCann, *supra* note 78, at 340 (“[L]eft to their own devices, markets generate as much economic chaos as order. One might as well rely on a tornado to usher in the warm, gentle breezes of springtime as trust markets of themselves to create a tolerably just distribution of the economic resources they help generate.”).

81. See Silecchia, *supra* note 35, at 1183 (noting that subsidiarity “is a view that lesser communities are often the ones best able to fill the needs of justice—and fill them quickly,” but “[n]aturally, if these small communities are themselves unjust or in need, then more extensive legal intervention may be needed”).

82. Crosson, *supra* note 53, at 170-71.

responsibilities to state governments may be advantageous for a variety of other reasons, there is no indication that it expands or enhances the role of mediating structures in the provision of welfare:

Some have argued, in the context of welfare reform, that the deficiencies associated with government support can be dealt with by devolving government decisions to the states, through block grants. The idea is to move decision making to levels of government that are closer to the people. But while there are many good reasons to move social programs to the states, it is by no means clear that this reform alone would foster the growth of mediating structures—it may even impede it. States, in fact, are just as subject as the federal government to pressure from special interests who feel threatened by mediating structures—and more so in some places. This susceptibility to pressure at the state level is why so many of the regulations and legal barriers frustrating mediating structures emanate from state governments. State welfare bureaucracies also tend to be even more hostile to innovative community-based institutions than federal officials.<sup>83</sup>

Notwithstanding a particular policy's impact on mediating structures, it must be remembered that subsidiarity is not simply an abstract principle of governance, but rather a practical framework for solving real problems. While government action should be undertaken with a view toward fostering the efficacy of mediating structures, the absence of such structures does not preclude attempts to solve pressing problems. And where localized problem-solving is not feasible or effective, subsidiarity contemplates direct intervention by the federal government.<sup>84</sup> Once it is understood that federal government intervention is possible under subsidiarity, the prudence of a proposed intervention remains to be determined. As modern governments' real-world reliance on subsidiarity

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83. Stuart M. Butler, *Practical Principles*, in *TO EMPOWER PEOPLE*, *supra* note 63, at 116, 117-18.

84. See Langan, *supra* note 29, at 251 (arguing that subsidiarity's "preference for local and regional solutions over national ones, for national approaches over international, for private rather than public sources of action for the common good . . . can always be overturned in light of experience, and the operation of the principle presupposes the coordinating and rectifying functions of the state"); McGovern, *supra* note 18, at 450 ("Subsidiarity thus means seeking first and wherever possible to address social problems at more local levels, but it suggests that government action may be necessary when, because of the magnitude of the social needs (or failures to address them), the problems and needs are not being dealt with effectively."); cf. J. Bryan Hehir, *The Social Role of the Church: Leo XIII, Vatican II and John Paul II*, in *NEW WORLD ORDER*, *supra* note 39, at 29, 32 (acknowledging that while "subsidiarity seeks to preserve a sphere of freedom and initiative in society," it "is balanced by the demands of socialization which require a positive conception of the state's socioeconomic responsibilities toward the poor"); Hehir, *supra* note 1 ("It is a manifestation of an ignorance of the [Catholic social] tradition for one to take this [subsidiarity] principle and argue that the state and other public institutions do not have responsibilities to the poor.").



shows, the answer is far from obvious.

### III. SUBSIDIARITY AS A MODEL OF GOVERNANCE

#### *A. Subsidiarity and the European Union*

Subsidiarity's European roots run deep. The word itself comes from the German translation of *Quadragesimo anno*, an encyclical "heavily influenced by the German church."<sup>85</sup> Germany also was where "[s]ubsidiarity made the transition from a principle of social organization to an explicitly political rule of institutional design."<sup>86</sup> It was central to Germany's reconstruction after World War II "and was a natural antithesis to the extreme centralizing tendencies of the Nazi regime."<sup>87</sup>

The European Union (EU) looked to subsidiarity as an organizing principle early on, as the term "appears in debates on EC reform as early as 1975."<sup>88</sup> This culminated with the 1992 Treaty of Maastricht, in which "the subsidiarity principle was proclaimed a guideline for further European integration."<sup>89</sup> The Maastricht Treaty expresses the principle as follows:

In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the member-States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.<sup>90</sup>

The EU's reliance on subsidiarity is certainly not without criticism. Paul Marquardt argues that the use of subsidiarity to solve "the tension between the EU and the survival of national polities and societies" is animated by the "spirit of the institutional quick fix."<sup>91</sup> While recognizing other commentators' assertions that subsidiarity is "weak, subjective, and open-ended," Marquardt contends that

even if subsidiarity works exactly as intended, its principles are fundamentally corrosive to rather than supportive of the sovereignty of the nation-state [because] the underlying logic of subsidiarity reduces the claim of rightful governance to a technocratic question of functional efficiency that will eventually undercut the nation-state's claims to

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85. Marquardt, *supra* note 32, at 619.

86. *Id.*

87. *Id.* at 620.

88. *Id.*

89. Spieker, *supra* note 28, at 26.

90. Treaty Establishing the European Community, Feb. 7, 1992, art. 3b, 63 COMMON MARKET L. REP. 573, 590 (1992).

91. Marquardt, *supra* note 32, at 617.

loyalty.<sup>92</sup>

Marquardt's fear that subsidiarity may ultimately undermine member states' sovereignty is less of a concern in the United States, where expansion of federal power is limited by constitutional constraints, not just functional considerations.

Other criticisms of subsidiarity in the EU context, however, are more broadly applicable. As Paul Marquardt explained, conducting a subsidiarity analysis of a proposed EU action is easier said than done:

Subsidiarity requires an analysis of the comparative utility of EU action, Member State action, and no action at all. Predicting the outcome of a known policy is difficult enough, but trying to predict what action the Member States or the market would take in the absence of EU action adds a virtually insurmountable layer of difficulty to the task.<sup>93</sup>

This contributes to the related problem of non-justiciability, as

[t]he imprecision of [subsidiarity's] meaning, together with the difficulty of producing a definitive objective analysis of such a complex policy question as the "best" level of national action, means that it is highly unlikely the principle can be meaningfully applied to stop expansionist exercises of power. The judgments involved are inherently political and uncertain, and the European Court of Justice is ill-equipped to second-guess the policy analyses of the other Community organs.<sup>94</sup>

Subsidiarity's multiple meanings, "its incomplete application to EU institutions," the difficulty of analyzing the proposed action in light of subsidiarity's objectives, and the lack of an effective mechanism by which it can be enforced have created formidable obstacles to its effective implementation in the EU.<sup>95</sup> At least in part because of these shortcomings, subsidiarity is an ideal "often extolled but seldom adhered to by the rapidly centralizing European Union."<sup>96</sup> The criticisms are given a new slant in the American context, in which subsidiarity provides an unstated but very real framework for government action.<sup>97</sup>

### *B. Subsidiarity and American Federalism*

Although subsidiarity has until recently remained largely anonymous among the American public, its impact in the United States is readily discernible. The

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92. *Id.* at 618 (footnote omitted).

93. *Id.* at 630.

94. *Id.*

95. *Id.* at 628.

96. James L. Huffman, *The Impact of Regulation on Small and Emerging Businesses*, 4 J. SMALL & EMERGING BUS. L. 307, 316 (2000).

97. Currie, *supra* note 16, at 363-64 ("In Germany the subsidiarity principle is stated expressly in the constitution, and it has been roundly ignored. In the United States the Constitution says nothing about subsidiarity, but it is widely followed in practice." (footnote omitted)).



principle is not formally enshrined as a constitutional check on federal power, but there is little dispute that subsidiarity plays a significant role in American governance. From executive orders requiring that a proposed federal action be weighed against the efficacy of state action,<sup>98</sup> to congressional restraint in areas of state regulatory competence, to judicial enforcement of state-federal boundaries, much of this country's political and legal landscape comports fully with subsidiarity's ideal. Lawmakers and judges do not necessarily subscribe to subsidiarity as a freestanding doctrine, but as "the guiding principle of federalism in the United States."<sup>99</sup> In that regard, subsidiarity represents "an aspect of the original theory of American federalism which held that state governments will be more responsive than the national government to the public will [and] better informed about local circumstances."<sup>100</sup>

Subsidiarity acts as a check on congressional action not in any formal sense, but as a largely unspoken, self-imposed restraint. David Currie observes that "[h]owever broad its authority, Congress is ordinarily reluctant to supplant state action so long as the states are up to the task."<sup>101</sup> It is this sense of restraint that underlies many instances of congressional inaction, as well as statutes that give states flexibility in meeting certain baseline federal standards.<sup>102</sup> For some federal legislators, subsidiarity is more than an unspoken guideline. Judge James Buckley of the D.C. Circuit, for example, recalls that when he was a Senator, he "would consciously apply the rule of subsidiarity, which predates the Constitution, in deciding whether a particular responsibility was appropriate for the federal government."<sup>103</sup>

George Bermann points out that congressional reliance on subsidiarity is difficult, if not impossible, to trace because

Congress' criteria for assessing the necessity for federal intervention do not in fact seem to be especially well-defined, and it is certainly far from clear that these criteria entail a prior assessment of the states' own ability, acting alone or in concert, to achieve the objectives that Congress has.<sup>104</sup>

Further, given the dispersal of legislative power among committees and

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98. Such executive orders have not been limited to Republican administrations, as they continued uninterrupted through the Clinton presidency. See Bermann, *supra* note 14, at 436-47.

99. Currie, *supra* note 16, at 359.

100. Huffman, *supra* note 96, at 316. But see Bermann, *supra* note 14, at 404 ("[A]lthough federalism conveys a general sense of a vertical distribution, or balance, of power, it is not generally understood as expressing a preference for any particular distribution of that power, much less dictating any particular inquiry into the implications of specific governmental action for that distribution. In this respect, federalism and subsidiarity, though of course closely related, are quite different.").

101. Currie, *supra* note 16, at 363.

102. See *supra* note 14 and accompanying text.

103. James L. Buckley, *Reflections on Law & Public Life*, 1 GREEN BAG 2D 391, 396 (1998).

104. Bermann, *supra* note 14, at 409.

subcommittees, “an attachment to subsidiarity on the part of Congress . . . would be difficult to document even if it existed.”<sup>105</sup> But even Bermann acknowledges that formally enshrining subsidiarity in the legislative process would be relatively simple, as Congress could require, through the House or Senate Rules, that “the committee report on a bill . . . assess the states’ capacity to deal with the problem and . . . demonstrate the need for federal intervention.”<sup>106</sup> Alternatively, a standing body within Congress could review bills from a subsidiarity perspective before a final vote.<sup>107</sup> In any event, formalizing subsidiarity’s role is, to a great extent, beside the point. Whatever justification is offered by individual legislators or Congress collectively for their decisions—be it subsidiarity, federalism, efficiency, or general prudence—the bottom line is that those decisions frequently fall within subsidiarity’s substantive mandate.

Subsidiarity is even less likely to be expressly referenced as the basis of decisions by American judges. Although it has been suggested by scholars, as noted above, that the subsidiarity principle is found within the Tenth Amendment<sup>108</sup> and the Necessary and Proper Clause,<sup>109</sup> at this time such views have not been expressly embraced by members of the federal judiciary. And though the common ground between subsidiarity and federalism has been noted by one member of the Supreme Court,<sup>110</sup> the principle rarely surfaces in case law.

That is not to say, however, that subsidiarity does not influence the way judges approach the controversies before them. At one level, judges implicitly enforce subsidiarity to the extent it mirrors their views on the Tenth Amendment. More fundamentally, subsidiarity’s elevation of function over doctrine is discernible in many court decisions bearing on federalism concerns. David Currie argues that subsidiarity’s influence can be seen in the New Deal Supreme Court bowing under “the pressure of perceived necessity” in order “to find room in the miserly enumeration for pervasive regulation of the entire national economy and for federal subsidies to whatever was good for the country.”<sup>111</sup> As a more recent example, Currie points to *United States v. Lopez*,<sup>112</sup> in which

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105. *Id.* at 410.

106. *Id.*

107. *Id.* at 410-11.

108. See Kmiec, *supra* note 20, at 215 (“The principle of subsidiarity is an important, if judicially disregarded, portion of the American Constitution’s Tenth Amendment that reserves to the state, or to the people, ‘powers not delegated to the United States by the Constitution.’” (footnote omitted)).

109. See Gardbaum, *supra* note 21, at 836 (“[T]here is a more plausible constitutional basis in the American context than either the Commerce Clause or the Tenth Amendment for the type of consideration that subsidiarity might be held to require the constituent political entities to be given: the Necessary and Proper Clause.” (footnote omitted)).

110. See *United States v. Morrison*, 529 U.S. 598, 663 (2000) (Breyer, J., dissenting) (citing law review articles linking subsidiarity and federalism).

111. Currie, *supra* note 16, at 363.

112. 514 U.S. 549 (1995).



Congress struck down the federal gun-free school law and suggested that “[t]he Court is less likely to strain to find congressional power in areas where there is no need for federal action. The true reason for the *Lopez* decision may be that the states were as capable as the federal government of punishing children who carried guns to school.”<sup>113</sup> As with the legislative branch, the judiciary’s adherence to the subsidiarity principle is reflected not in their choice of words, but in the substance of their decisions.

Evidence of subsidiarity’s influence in the United States traces back to the nation’s origins. Alexis de Tocqueville observed that “at the head of any new undertaking, where in France you would find the government or in England some territorial magnate, in the United States you are sure to find an association.”<sup>114</sup> Tocqueville applauded this uniquely American trait and he echoed subsidiarity’s mandate as he warned of the “vicious circle of cause and effect” arising from the fact that “[t]he more government takes the place of associations, the more will individuals lose the idea of forming associations and need the government to come to their help.”<sup>115</sup> Michael Novak notes that Abraham Lincoln formulated his own vision of subsidiarity in pronouncing that

[t]he legitimate object of government is to do for a community of people whatever they need to have done but cannot do at all, or cannot so well do for themselves in their separate and individual capacities. In all that people can individually do as well for themselves, government ought not to interfere.<sup>116</sup>

Given the expansion of federal power in the last century, it can hardly be disputed that American lawmakers have often deviated from subsidiarity as their guiding principle. Nevertheless, the degree and permanence of the concern raised by such expansion is itself evidence that subsidiarity has maintained more than a foothold on the national psyche.<sup>117</sup> Examples abound of Americans’ belief that societal functions should be performed by local entities or individuals to the extent that they can perform them effectively.<sup>118</sup> Even apart from political or sociological considerations, some commentators see greater potential for subsidiarity’s application in the future because of increased technological

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113. Currie, *supra* note 16, at 363.

114. ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA* 513 (George Lawrence trans., J.P. Mayer ed., 1988).

115. *Id.* at 515.

116. Michael Novak, *Seven Tangled Questions*, in *TO EMPOWER PEOPLE*, *supra* note 63, at 132, 140. Interestingly, the papal encyclopedia *Sacramentum mundi* lists this statement of Lincoln’s as the earliest formulation of the subsidiarity principle. *Id.* at 139-40.

117. See Crosson, *supra* note 53, at 171 (“Over the years, the extent of powers implicit in those explicitly delegated to the national government has grown, but no one familiar with our continuing political discourse can be ignorant of the fact that there is a constant concern about the expansion of federal jurisdiction.”).

118. See *id.* at 171-72 (giving example of states exercising authority over education and allowing schools to be established by private groups and individuals as long as they meet certain minimal standards).

capabilities.<sup>119</sup> Coupled with compassionate conservatism's incorporation of the principle, subsidiarity's influence on the shape of American government is likely to be even more pronounced in the coming century.

Subsidiarity's persistent visibility in the fabric of American governance calls into question the power and relevance of the criticisms leveled against it in the European context. Even though the grounds for applying subsidiarity in the United States are largely unstated and a mechanism for enforcing compliance is nonexistent,<sup>120</sup> the principle is deeply ingrained in the structure of our federal system. Indeed, "[i]t would be hard to think of a more American principle of social structure than subsidiarity."<sup>121</sup> The lack of a viable means of enforcement and widespread unfamiliarity with its substance preclude full realization of subsidiarity's objectives in this country. The fact remains, however, that much of today's legislative and judicial decision-making reflects a pursuit of subsidiarity's objectives, whether explicitly acknowledged or not. Where the hodgepodge of judicial philosophies, canons of statutory interpretation, and legislative priorities preclude any comprehensive theory of government action, subsidiarity's basic framework comes surprisingly close to capturing the prevailing mindset.

Given subsidiarity's impact in the United States, debating its enforceability or level of institutional recognition seems a largely academic exercise. The more pressing problem is posed by subsidiarity's apparently elusive meaning. In both the United States and Europe, the principle is prone to manipulation by whoever enlists it in service of a particular political agenda. In one sense, that may be unavoidable, for if a societal function is to be performed by the lowest-level actor capable of performing it effectively, the judgment as to what constitutes effective performance may elicit an equally broad spectrum of opinions as if the decision were debated outside of subsidiarity's framework. Compassionate conservatism's reliance on subsidiarity tends toward the opposite extreme, as the effectiveness analysis is often subsumed by the tendency toward devolution. Under either extreme, subsidiarity appears to be little more than window dressing for preconceived political outcomes. Unless broader principles can be formulated to govern subsidiarity's real-world applications, it is of little value in public policy debates, and its current one-sided portrayal is of no practical import.

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119. See, e.g., Breger, *supra* note 17, at 424 (arguing that "advances in computer and media technology increase the potential of government accountability and . . . increase implementation of the principle of subsidiarity, or, in the American context, devolution of political power to state and local governments").

120. "[T]he U.S. system offers few political or legal guarantees that the federal government will act only when persuaded that the states cannot or will not do so on their own." Bermann, *supra* note 14, at 403.

121. Crosson, *supra* note 53, at 171.



## IV. SUBSIDIARITY AND GOVERNMENT ACTION: OPERATIVE PRINCIPLES

As subsidiarity emerges from anonymity and into President Bush's theory of governance, public perceptions of its meaning will be determined largely by the particular legislative proposals that it is invoked to support. Those who find value in subsidiarity but object to Bush's politics will be tempted to utilize the principle as a basis for objecting to his proposals on a case-by-case basis. Such a short-sighted approach, while perhaps politically expedient, would forego a valuable opportunity to make subsidiarity a meaningful component of public policy debates in this country. To remain faithful to the principle's origins, certain guidelines for its application must be extracted from Catholic social theory. Moreover, to avoid relegating subsidiarity to the status of partisan rhetoric, it must be given substance that does not rise or fall with the success of a particular legislative proposal or simply track a party's platform. At the same time, however, its substance cannot be elevated to mere abstraction; it must be applicable to real-world policymaking.

Despite the sense of certainty underlying the recent political invocations of subsidiarity, it must be readily acknowledged that "[s]ubsidiarity means different things to different people," with one commentator going "so far as to call it 'an empty shell devoid of concrete substance . . . a golden rule, a fashionable term, a concept with which anyone might agree in principle, because all can define for themselves what it means in any specific case.'"<sup>122</sup> In one sense, subsidiarity's lack of substantive content renders it vulnerable to being captured by those with a preexisting agenda. By emphasizing aspects of subsidiarity's procedural framework that support devolution and disregarding those that do not, today's champions of subsidiarity have filled its "empty shell" with decidedly partisan substance. In another sense, however, the lack of substantive content seems to suggest that politically motivated interpretations of subsidiarity may not be so misguided after all. If the principle simply represents an ever-malleable procedural form, is there any use in attempting to show that certain substantive laws and priorities are more consistent with its objectives than others? Once the partisan substance is removed, is there anything left to subsidiarity?

While policy analyses conducted pursuant to subsidiarity may not always lead to obvious answers and may themselves be influenced by political considerations, broader conclusions may still be drawn when proposed government actions are weighed against subsidiarity's objectives. That there will be political aspects to subsidiarity's day-to-day application is inescapable given the nature of democratic lawmaking. Political actors will often disagree on the most effective level of action, with empirical and anecdotal evidence supporting

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122. Marquardt, *supra* note 32, at 628 (quoting Guenther F. Shaefer, *Institutional Choices: The Rise and Fall of Subsidiarity*, 23 *FUTURES* 681, 688 (1991) (omission by Marquardt)); *see also* Schere, *supra* note 18, at 178 ("It is evident that the economic and organization sciences, in spite of their important contribution to the definition or understanding of the subsidiarity phenomenon, cannot define in a definitive manner what subsidiarity is since the meaning of that term is contingent upon a given situation." (footnote omitted)).

both sides.<sup>123</sup> Subsidiarity's value derives not from its ability to foster apolitical resolutions to debates over effectiveness, but from the framework it provides for those debates.<sup>124</sup> Contrary to the tone of current public policy arguments invoking subsidiarity, devolution is not the sole component of that framework. Other implementing guidelines are readily apparent from subsidiarity itself and the Catholic social theory from which it arises. Applying those guidelines to real-world issues reveals that, in many areas, the priorities reflected in compassionate conservatism are not consistent with those underlying subsidiarity. When conscientiously applied, subsidiarity will not always lead to the devolution of functions from the federal government to lower bodies.

Several basic principles emerge from even a cursory reading of subsidiarity and its Catholic social theory roots. First, a meaningful distinction must be drawn between mediating structures and megastructures under any policy that purports to apply subsidiarity. Second, subsidiarity does not call simply for the recognition of mediating structures, but for their empowerment. Third, the localization of societal problem-solving, mandated by subsidiarity, carries with it an obligation to ensure that individuals are equipped to participate fully in collective decision-making regarding issues that affect them and their communities. By applying these principles to particular areas of law, it becomes clear that although certain aspects of compassionate conservatism's decentralizing agenda are consistent with subsidiarity, that agenda falls short of subsidiarity's ideal to the extent that it omits the limited but active federal role that is essential to realizing subsidiarity's ultimate objectives.

#### *A. Subsidiarity Values Mediating Structures over Megastructures*

One attribute of the devolutionary invocation of subsidiarity is the tendency to focus on mediating structures exclusively as bulwarks against government authority, which tends to portray all nongovernment entities as equally laudable protectors of the civic interest. While subsidiarity does place limits on state

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123. See Marquardt, *supra* note 32, at 628-29 ("[T]he analysis of the level at which a policy may best be implemented is bound to be highly subjective and can cut in favor of centralization as well as against it.").

124. See Bermann, *supra* note 14, at 386 ("The fact that subsidiarity calls for judgments that are invariably political and often immensely speculative is not, however, an argument against requiring the institutions to observe it. Neither is the fact that the analysis may rarely yield obvious results."); Francis Canavan, *The Popes and the Economy*, 11 NOTRE DAME J.L. ETHICS & PUB. POL'Y 429, 437 (1997) (contending that while subsidiarity "is a purely formal principle that does not answer substantive questions," it "is neither meaningless nor useless, because it inculcates a steady bias toward decentralization, freedom, and initiative"); McGovern, *supra* note 18, at 460 (arguing that subsidiarity serves "only as a guiding principle, a principle with two parts: problems are better solved at lower levels by smaller groups, but some require measures at a higher level by larger institutions. The principle itself does not tell us which legitimate social needs can be resolved at lower levels without recourse to government programs; only experience and empirical evidence can determine this (and analysts sharply disagree about both).").



intervention, the entities that fill the resulting power vacuum are not necessarily ideal simply because they arise from the operation of the market. Corporations do not always act as the mediating structures envisioned by subsidiarity. Especially as they increase in size and hierarchy, corporations can function as megastructures,<sup>125</sup> which reduce individuals' powers of self-betterment and alienate members of society from each other.

Also frequently missing from arguments favoring devolution is any discussion of the active societal role envisioned for mediating structures. In focusing on mediating structures, "we have tended to do so negatively by stressing very one-sidedly their obvious importance as bulwarks against statism and have yet to agree upon a positive and structured role for these organizations in the operation and planning of the economy."<sup>126</sup> Mediating structures cannot be judged solely by the barriers they present to the encroachment of megastructures, but also by the vehicles they provide for self-empowerment and efficacious group action. In this regard, the fact that a large corporation has the political and economic muscle to prevent government expansion into an area of interest to the corporation does not mean that the corporation is a mediating structure. Both corporate and government power share the capacity to alienate individuals:

The reliance on the state, simply because of its size, makes difficult the identification of the individual with the common good. It is difficult for anyone, unless unusually powerful, to see what differences their job, their vote, their honesty, or any number of other actions have to do with the "common good" of the country. The same problem holds true in a large corporation as well as in relation to the market itself. Personal responsibility is undermined by this mismatch between the lack of individual control over decisions affecting particular persons and the abstractness of government or markets responsible for solving social problems.<sup>127</sup>

The corporation is a money-generating enterprise, not a means for furthering subsidiarity's objectives,<sup>128</sup> and any effort to enhance corporations' mediating

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125. See Neuhaus & Berger, *Mediating Structures*, *supra* note 63, at 214.

126. George G. Higgins, *Trade Unions, Catholic Teaching and the New World Order*, in *NEW WORLD ORDER*, *supra* note 39, at 351, 357; cf. Elshtain, *supra* note 8, at 589 (calling for civil society advocates "to set forth the criteria under which some kinds of associations are found worthy of endorsement and affirmation as part of a well functioning civil society, and which groups, by contrast, run counter to that ideal").

127. Fort, *supra* note 68, at 428 (footnote omitted).

128. Dennis McCann explains:

The modern business corporation is not, nor could it ever be, a substitute for either the church or the state; its purpose in the unfolding of the history of the redemption is different from both. The corporation's purpose is to create wealth, that is, to produce the economic resources necessary for authentic social development. . . . Given the continually shifting pattern of needs expressed by those whom the corporation is meant

function must acknowledge as much. That said, corporate supremacy in the global economy gives corporations an unsurpassed role in shaping the way individuals relate to their environments.<sup>129</sup> Whether they are viewed “as a very public private institution or a very private public institution, corporations have a rich potential to create citizens,” but not “if the lessons learned at work have nothing to do with a corporate common good that simultaneously empowers individuals.”<sup>130</sup>

While the essential nature of corporations cannot be reconfigured to better fulfill subsidiarity’s vision of mediating structures, that does not render irrelevant all government policies toward corporations. The environment in which a corporation operates has a significant impact on its tendency to function as a mediating structure or megastructure. Specifically, corporations are more likely to function as mediating structures in a market environment in which it is reasonably easy for new corporations to gain entry and small corporations are able to thrive and prosper. Where market power is used to preclude new entries and force smaller entities out of existence, the landscape is more likely to be dominated by megastructures. Even if large corporations are still subject to competitive pressures, their sheer size and hierarchy make it much more difficult for individual employees to have a discernible influence over the priorities and values reflected in their employers’ decisions. These same characteristics also limit megastructures’ responsiveness to the input of individual consumers, thereby reducing consumers’ influence over the goods and services making up their everyday existences.

Corporations’ status as mediating structures or megastructures is determined in part by government enforcement of antitrust law. It is widely agreed that President Bush will enforce the antitrust laws less aggressively than his predecessor.<sup>131</sup> Bush’s preference for allowing the market to sort out anti-

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to serve, this form of divine governance is likely to be far more tentative and improvisational than either the church or the state.

McCann, *supra* note 78, at 339-40.

129. See Litonjua, *supra* note 30, at 215 (arguing that the modern corporation “has taken the place of mediating institutions, such as political parties, labor unions, voluntary organizations, that constituted the vitality of American democracy, to form a more perverted form of corporate politics”).

130. Fort, *supra* note 68, at 433.

131. See, e.g., William J. Holstein, *Business’s Biggest Stake in a Bush Win: Giving the Bum’s Rush to the Trustbusters*, U.S. NEWS & WORLD REP., Dec. 11, 2000, at 57 (reporting that experts suspect a “broad[] pullback” from the Clinton administration’s “aggressive enforcement”); John B. Judis, *Trust Walk: Why the Bushies Love Monopoly*, NEW REPUBLIC, June 11, 2001, at 25 (arguing that Bush’s nominees to run the Federal Trade Commission, Federal Communications Commission, and the Justice Department’s antitrust division “herald a radical shift in the enforcement of America’s antitrust laws: Under the Bush administration, there may not be any”); *Choice for FTC to Mean Antitrust Shift*, HOUST. CHRON., March, 22, 2001, at 9 (“Legal experts predicted today that [the nomination] is certain to lead to a significant easing of reviews of corporate mergers and a far less aggressive policy towards monopolization cases.”); Donald



competitive behavior does not necessarily comport with subsidiarity simply because it eschews government action. Subsidiarity certainly favors non-government solutions in many contexts, but the principle also is “useful both for identifying various forms of marginalization, to the extent that these are a result of disorders in the routine exercise of institutional power, and for transforming these same institutions in the direction of the ideal of solidarity.”<sup>132</sup> Antitrust is one area where government action seeks to remedy seemingly routine exercises of corporate power that collectively have marginalized employees, consumers, and even those whose entrepreneurial hopes have been dashed by monopolistic barriers to market entry.

On a broad level, aggressive antitrust enforcement would seem to go hand-in-hand with subsidiarity, even under neoconservatives’ formulation of subsidiarity’s objectives. Novak insists that “[p]hilosophically and theologically, a regime emphasizing the broadest possible distribution of private property empowers citizens to act in the world of material things through material instruments of their own.”<sup>133</sup> Because “[i]t is important for economic development to proceed universally, without leaving anybody out,” he suggests that we “[m]aximize popular ownership, especially home ownership, the ownership of small businesses, workers’ shares in commercial or agricultural corporations, and the like.”<sup>134</sup>

Recognizing the economic equality aspect of subsidiarity does not necessarily require the redistribution of wealth, but it suggests that at least some effort must be undertaken to prevent individuals from losing access to economic resources due to anticompetitive corporate action. Pope John Paul II recognized as much with his admonition that “[t]he State has the . . . right to intervene when particular monopolies create delays or obstacles to development.”<sup>135</sup> One much-publicized example arises from the Microsoft litigation, where the software megastructure stands accused of tying its products to prevent Netscape from competing in the market. Using existing market power to prevent others from attaining a place in the market for themselves runs counter to subsidiarity because it both negates a potential competitor’s efforts toward economic self-determination and limits consumer choice.<sup>136</sup>

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Lambro, *Bush Said Unlikely to Pursue Microsoft*, WASH. TIMES, Dec. 17, 2000, at C1.

132. McCann, *supra* note 78, at 347.

133. MICHAEL NOVAK, *THIS HEMISPHERE OF LIBERTY* 55 (1990).

134. *Id.* at 55-56.

135. John Paul II, *supra* note 42, para. 48.

136. Bush’s desire to resolve the Microsoft litigation quickly has contributed to the impression that antitrust enforcement is not a top priority of the new administration. See, e.g., *A Risk Worth Taking*, WASH. POST, Nov. 4, 2001, at B6 (“A federal appeals court affirmed that Microsoft broke the law, yet Justice has settled the case in exchange for restrictions on the company’s conduct that are less stringent than those discussed in settlement talks before the company’s guilt was established.”); Jonathan Krim, *Microsoft, U.S. Near Antitrust Settlement*, WASH. POST, Nov. 1, 2001, at A1 (“The gulf between federal and state prosecutors has widened since the Bush administration took office, and the states have been concerned for several months that the Justice

While the scope and speed of Microsoft's rise to dominance may be unusual, it reflects capitalism's inherent tendency toward the consolidation of market power. Smaller companies and start-ups are by no means a vanishing breed, "but there is also a natural countertendency toward larger combinations, the formation of temporary monopolies (as when a new invention allows a firm a few years' advantage over other firms), and the growth of small firms into ever-larger ones."<sup>137</sup> Antitrust law has, to a certain extent, come to embrace this market tendency:

In the 1960s, U.S. antitrust law was synergistic with civil rights law; it protected the underdog. It protected the freedom of independent traders to sell where and to whom they chose, and protected their right not to be fenced out of any significant market by the use of leverage. It valued market governance by impersonal forces, rather than by dominant firms.

This humanistic form of antitrust did not survive an economic recession, growing international competition, and inroads by foreign competitors into U.S. markets. The Reagan revolution of the early 1980s reversed the antitrust paradigm; since then the common wisdom has been: Competition is an economic modality for the purpose of producing efficient markets, and antitrust law is a tool to aid the process in the event of market failure.<sup>138</sup>

In looking to the market itself as the primary guardian of competition, the Bush administration falls prey to the conservative tendency to exhibit "the weakness of the Left in reverse" by being "highly sensitive to the alienations of big government, but blind to the analogous effects of big business."<sup>139</sup> Bush avoids intervention by the government megastructure, but at the cost of giving free rein to corporate megastructures. The relevant distinction under subsidiarity is not between types of megastructures, but between megastructures and mediating structures. Absent a competitive and open market, it is unlikely that Microsoft or General Motors will effectively facilitate the localized decision-making and individual empowerment that lie at the core of subsidiarity. Antitrust necessitates a specific higher-body function to ensure that lower bodies are equipped to fulfill their more general functions. Allowing the federal government to play an active role in checking the power of large corporations is not an improper encroachment by a megastructure, but a necessary protection for mediating structures.

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Department was seeking to conclude the case with a settlement that they and Microsoft competitors would view as inadequate.").

137. Novak, *supra* note 116, at 135.

138. Eleanor M. Fox, *Antitrust and Regulatory Federalism: Races Up, Down, and Sideways*, 75 N.Y.U. L. REV. 1781, 1798 (2000) (footnote omitted).

139. Neuhaus & Berger, *Mediating Structures*, *supra* note 63, at 218.



*B. Mediating Structures Must Be Empowered*

Subsidiarity is not simply a market-based framework under which individuals have the theoretical freedom to conduct their lives and solve their problems as they see fit, but rather a call for individuals to be equipped with the real-world tools for bettering themselves and those around them. In this regard, the principle's origin in Catholic social theory reflects a tangible concern for the economic rights of workers as they sell their labor on the market. In recognizing a role for the government in ensuring workers' well-being, Catholic social theory departed from classical liberalism, which "was not in a position to perceive the power problem that exists between employee and employer."<sup>140</sup> The Church contends that the "human dignity of the worker and demands for a just wage . . . are integral parts of a work relation" and "precede[] all contractual agreements" between the worker and the employer.<sup>141</sup>

Through statements such as the 1961 encyclical *Mater et magistra*, which addresses economic participation by workers, and the 1965 pastoral constitution *Gaudium et spes*, which calls for worker participation in workplace decision-making, the popes have consistently focused on the ability of workers to have input in the conditions of their employment. Even John Paul II, who tends to emphasize the negative aspect of subsidiarity, defends the solidarity of workers and their right to organize in the 1981 encyclical *Laborem exercens*. In addition, his 1991 encyclical *Centesimus annus*

establishes that the rightfulness of workers' efforts to come to justice in their dignity as humans, through more room for participation in the life of the business among other things, so that, while they work together with others and under the direction of others, they can work for themselves in a certain sense through the efforts of their intelligence and freedom.<sup>142</sup>

Other sources of church teaching echo the papal emphasis on the well-being of workers.<sup>143</sup>

While Catholic social theory certainly recognizes the existence of economic laws, it does not concede that such laws are superior to the moral law. "For example, if it is economically unfeasible for employers to pay a living wage for

140. Rauscher, *supra* note 38, at 75.

141. *Id.*; see also Williams, *supra* note 43, at 8 (noting that Catholic social theory "always has understood that, although the right to private property is important, the worker's right to a 'just wage' takes precedence over an employer's right to bargain for the cheapest wages possible").

142. De Jonghe, *supra* note 34, at 154.

143. See, e.g., *id.* at 153-54 (noting that the Congregation for the Doctrine of the Faith's 1986 *Instruction About Christian Freedom and Liberation* "argues that human dignity is the criterion to judge the situation of the employees"); U.S. Catholic Bishops, *Economic Justice for All* (1986), <http://www.osjspm.org/cst/eja.htm> (calling for participatory structures to foster cooperation in economic life, including profit-sharing, worker shareholding, administrative participation, and labor unions).

labor because of the prevailing conditions of competition,” Catholic teachings suggest that “we should change the conditions of competition . . . by setting a legal minimum wage, by making collective bargaining legally obligatory, by encouraging cooperation among associations of employers and employees, by labor participation in management or by still other means that are not beyond the reach of human intelligence.”<sup>144</sup> In line with subsidiarity’s insistence that individuals be equipped with tools of self-betterment, “[t]he connection between personal work and personal property of attained goods must be directly evident to members of a particular society.”<sup>145</sup> When property proportions are not fairly divided, “[h]ere lies a challenge for the state.”<sup>146</sup>

Beside determining the proportion of property they are able to secure for their labor, workers’ ability to organize themselves is central to their attainment of subsidiarity’s objectives. The mediating function of voluntary associations is essential under subsidiarity, as it is in such groups that “individuals learn to compromise, persuade, and sublimate narrow self-interest for the greater good of the group.”<sup>147</sup> Groups are especially necessary in the economic sphere—a sphere “frequently relegated to self-interests, prudent investors, and invisible hands”—in order to direct “productive and service activities to the common good.”<sup>148</sup> In pursuing the common good, “subsidiarity provides an orientation for directing the group’s activity.”<sup>149</sup>

Organizing furthers subsidiarity’s objectives in two ways. First, it empowers individual workers to better themselves through their work. When serving its proper function, “[w]ork should enable the working person to become ‘more a human being,’ more capable of acting intelligently, freely, and in ways that lead to self-realization.”<sup>150</sup> Second, it connects them with other workers in a way that allows them to overcome interpersonal barriers in the realization of common goals. Cynthia Estlund argues that the workplace is “a crucial site for the forging of personal ties across lines that often divide people,” and that, by fostering such ties, “the workplace mediates between the individual citizen and the broader diverse citizenry.”<sup>151</sup> Jean Bethke Elshtain extols “trade unions as having the potential to play ‘an important role in renewing civil society.’”<sup>152</sup>

In these ways, unions are the most effective structures for mediating between individual workers and the largely impersonal and unforgiving marketplace. That is why the substantial decline in union membership is troubling not just for

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144. Canavan, *supra* note 124, at 435-36.

145. Rauscher, *supra* note 38, at 81.

146. *Id.* at 82.

147. Fort, *supra* note 68, at 428.

148. Philip J. Chmielewski, *Workers' Participation in the United States: Catholic Social Teaching and Democratic Theory*, 55 REV. SOC. ECON. 487, 498 (1997).

149. *Id.*

150. *Id.* (footnote omitted).

151. Cynthia L. Estlund, *Working Together: The Workplace, Civil Society, and the Law*, 89 GEO. L.J. 1, 30 (2000).

152. Elshtain, *supra* note 8, at 597.



purposes of economic equality, but also from a subsidiarity perspective. Today only 13.5% of the work force belongs to unions, the lowest percentage in sixty years and down from a peak of thirty-five percent in the 1950s.<sup>153</sup> Although “16 million jobs have been created since 1992,” the number of union members has fallen by 200,000.<sup>154</sup> Far from expressing alarm at unions’ demise, the Bush administration has exhibited, at best, a well-documented ambivalence toward the labor movement.<sup>155</sup> To many observers, this ambivalence has crossed into outright hostility. For example, soon after taking office, Bush issued executive orders opening government contracts to non-union bidding and effectively reducing unions’ political expenditures.<sup>156</sup> He has also indicated a willingness to block strikes entirely in key industries.<sup>157</sup> Union backers predict that Bush’s judicial appointees will not be at all sympathetic to their plight.<sup>158</sup>

In light of Bush’s proclaimed adherence to subsidiarity, his disregard for unions may be explained partly by his view of mediating structures as bulwarks against government encroachment, but not market encroachment. The narrow view is certainly not unique to Bush, as George Higgins contends that the “limited anti-statist understanding of the role of intermediate structures and organizations accounts, to some extent, for the massive and menacing lack of concern in conservative circles about the growing weakness of American unions.”<sup>159</sup> However, even under Bush’s anti-statist view of mediating structures, unions should merit attention. According to Thomas Kohler, “[c]ollective bargaining provides the only alternative to the pervasive state regulation of one of life’s primary relationships—employment. Indeed, it is no coincidence that piecemeal regulation of employment through legislatures and common-law courts markedly has increased as the practice of collective bargaining has declined.”<sup>160</sup> Unions encompass both the anti-statist and anti-market aspects of subsidiarity, as their mediating value stems from the fact that “[t]hey stand independently of

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153. Steven Greenhouse, *New Political Field Challenges Labor Leaders*, N.Y. TIMES, Feb. 12, 2001, at A21.

154. Steven Greenhouse, *Labor Leader Sounds Do-or-Die Warning*, N.Y. TIMES, Feb. 19, 2001, at A10.

155. Steven Greenhouse, *Secretary Promises to Listen to Unions but Expects Differences*, N.Y. TIMES, Feb. 15, 2001, at A21; Greenhouse, *supra* note 153.

156. See Steven Greenhouse, *Bush Is Moving to Reduce Labor’s Political Coffers*, N.Y. TIMES, Feb. 16, 2001, at A14.

157. See, e.g., Jeanne Cummings, *Bush Will Intervene to Head Off a Strike at American if Accord Isn’t Set by Sunday*, WASH. ST. J., June 26, 2001, at A4.

158. See Thomas Geoghegan, *No Love Lost for Labor*, THE NATION, Oct. 9, 2000, at 35 (“If a more progressive administration succeeds him and pushes through new labor law that would give U.S. workers a real right to join unions, a Bush Supreme Court packed with Antonin Scalia and Clarence Thomas types would gut it.”).

159. Higgins, *supra* note 126, at 358 (noting that “the silence of the conservative community in the United States on this issue has been thunderous in recent years”).

160. Thomas C. Kohler, *Civic Virtue at Work: Unions as Seedbeds of the Civic Virtues*, 36 B.C. L. REV. 279, 301 (1995).

the state and the organizations that employ their members.”<sup>161</sup>

This is not to suggest that all unions serve a positive mediating function under all circumstances. To the extent that large and centralized unions minimize the decision-making role of individual members, they certainly could qualify as megastructures. For the purpose of subsidiarity, individuals are not necessarily better off simply because an alienating government power is replaced by an alienating union power. However, because unions “come into being as a result of employee self-organization, and their health and continuing existence depends upon the ability of the members to maintain solidarity,”<sup>162</sup> unions are more likely to empower individual workers than either a distant government authority or a profit-oriented management would be. Kohler points out that “[i]f they are to succeed, the actions a union undertakes must reflect the consensus of its members,” and that “a collective bargaining agreement represents the achievement of a consensus between employer and employed about the order of their relationship.”<sup>163</sup> In this regard, “it is through their involvement in the collective bargaining process that average citizens can take part in deciding the law that most directly determines the details of their daily lives.”<sup>164</sup>

Just as the government cannot, consistent with subsidiarity, assume unions’ responsibility for protecting workers’ well-being, neither can employers govern the process by which workers’ interests are represented. The rise of management-led participation plans may be more cost-effective or politically palatable than unions in certain contexts, but they do not provide the same degree of empowerment to individual workers. As Thomas Kohler points out,

[i]n contrast to the collective bargaining model . . . which is founded on the formation of autonomous employee groups and assumes that workers and management have mutual as well as divergent interests, the managerially sponsored schemes have little room for unions and are based on convincing employees to see corporate goals as being identical with their own.<sup>165</sup>

Such plans are founded more on notions of persuasion and interest alignment, which, while valuable, cannot match collective bargaining’s ability to allow workers direct influence over their employment conditions.

One objection to a subsidiarity-based embrace of unions as mediating structures may derive from the traditional vision of union decision-making, in which members with minority viewpoints are effectively shut out of the collective action. Molly McUsic and Michael Selmi have proposed a “community of difference” model for unions that addresses this problem:

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161. *Id.*

162. *Id.* at 300.

163. *Id.* at 299.

164. *Id.* at 298-99.

165. Thomas C. Kohler, *Individualism and Communitarianism at Work*, 1993 B.Y.U.L. REV. 727, 738.



Unlike the pluralist model of legislation where each member votes his own exogenous best interest, and the union simply collects each vote and acts on behalf of the majority, in the community of difference model, unions would help develop worker interest in the face of a common opponent. In this respect, unions turn from being mini-legislatures to becoming mediating institutions with transformative aspirations much like the border cultures where changes occur through the clash of cultures. Unions would provide a forum to discuss different group interests, the presence and pervasiveness of difference within the workplace, and possible means for satisfying these various interests and perspectives.<sup>166</sup>

Under this model, “groups of workers would come together in dialogue to derive the best strategy for all the members of the group rather than concentrating on finding a position that can obtain majority support.”<sup>167</sup>

Even where unions are governed by majority rule, the fact that they give a voice to workers’ collective interests outweighs—from a subsidiarity perspective—their inability to provide specific representation of each worker’s opinion. Given the power disparity between individual workers and management, a collective voice is needed for workers to have any meaningful say over the conditions of their employment. This disparity also casts doubt on the notion that the decline of unions gives power back to individual employees. Because workers are “[e]ver less constrained by collectively set determinations,” they “are free to bargain and select the terms and conditions of their employment individually.”<sup>168</sup> As it works out, however, “this means that individuals have become increasingly dependent on their employers and the state to regulate the order of the employment relationship. Few actually participate directly in making and administering the law that governs their lives in the workplace.”<sup>169</sup>

Regardless of the economic or political shifts underlying the shrinking labor movement, “[t]he decline of union representation is a major loss for the mediating function of the workplace, for unions actively cultivate solidarity, egalitarian values, and democratic practices, and they multiply opportunities for constructive interaction among coworkers through the vehicles of union governance and collective bargaining.”<sup>170</sup> Unions’ demise is a troubling prospect under any reasonable interpretation of subsidiarity, which, along with Catholic social theory in general, holds that “the role of each level of social organization [is] to facilitate independent action by the groups below it, in the end supporting the maximum personal and spiritual development of the individuals who are the

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166. Molly S. McUsic & Michael Selmi, *Postmodern Unions: Identity Politics in the Workplace*, 82 IOWA L. REV. 1339, 1368-69 (1997).

167. *Id.* at 1369.

168. Kohler, *supra* note 165, at 740.

169. *Id.*

170. Estlund, *supra* note 151, at 70.

ultimate base of all organizations.”<sup>171</sup> This suggests that the government has a responsibility to protect the independence and vitality of unions so that they, in turn, may empower society’s workers. The response to unions’ decline, by leaving workers’ well-being up to their employers or the government, disregards the need for mediating structures between individuals and the world around them. To the extent that unions lack the numerical, economic, or political power to fulfill their mediating function, there is, contrary to the Bush administration’s interpretation of subsidiarity, cause for government action.

*C. Individuals Must Be Able to Participate Fully in Societal Decision-Making*

In emphasizing localized problem-solving, subsidiarity presumes that individuals will be equipped with the tools necessary to affect change in their own environment by participating fully in collective decision-making on the issues that impact them and their communities. Ensuring such participation requires more than protecting the abstract legal rights of citizenship; it requires a recognition of the practical and structural impediments to meaningful participation.<sup>172</sup> For example, the widespread exclusion of African-Americans from collective decision-making in southern states required higher-body action under any reasonable interpretation of subsidiarity.<sup>173</sup> In two other areas—campaign finance reform and environmental regulation—the Bush administration has overlooked obstacles to participation that must be addressed if subsidiarity is to be implemented as an operative theory of governance.

The gap between subsidiarity’s mandate and American reality is most clearly reflected by the manner in which campaigns are conducted in this country. Judging by the Bush administration’s half-hearted embrace of campaign finance reform,<sup>174</sup> its conception of subsidiarity overlooks the impact that campaign

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171. Marquardt, *supra* note 32, at 619.

172. See, e.g., McCann, *supra* note 78, at 347 (observing that “achieving social justice requires an assessment of institutions with respect to their success in empowering persons for participation,” and that “the principle of subsidiarity . . . seem[s] reflected specifically in the bishops’ concern for social justice and participation”).

173. Dan Millisor explains:

As the problem or challenge becomes larger or more universal, this [subsidiarity] principle calls upon larger and larger units of society to become engaged. Central to this principle are the words, “able” and “willing.” It might well be the case that a local community is able, yet unwilling, to be active with an issue. Thus, the Church recommended federal intervention in the case of racial desegregation in parts of the United States.

Dan Millisor, “*Crusaders for Justice, Pilgrims for Peace*”: *Global Human Rights and Catholic Social Teaching*, 25 OHIO N.U. L. REV. 315, 317-18 (1999); see also Silecchia, *supra* note 35, at 1179 (noting that John Paul II expressly urges in *Centesimus annus* that “the more that individuals are defenseless within a given society, the more they require the care and concern of others, and in particular the intervention of governmental authority” (footnote omitted)).

174. See, e.g., Dan Balz & Ruth Marcus, *Bush to Offer Campaign Finance Guidelines*, WASH.



finance has on the efficacy of political activity by individuals and the groups to which they belong. At first glance, subsidiarity may appear to favor the current regime under which groups and organizations may make unlimited “soft money” contributions to political parties or advocacy groups. As one critic argued, any restrictions on the amount and manner in which PACs and other political associations can fund campaigns “neglect or openly attack the basic human good of cooperation,”<sup>175</sup> the very underpinning of subsidiarity.

Such arguments ignore the reality of politics in America. Campaigns are dominated by corporations, political associations, and individuals wealthy enough to purchase candidates’ attention. Most of the entities of any political relevance are megastructures—national labor unions, corporations, or huge nationwide associations such as the National Rifle Association. Individuals feel alienated, not engaged with the political system, by virtue of these groups’ political largesse.<sup>176</sup> Individuals and voluntary associations without money have little influence on the political process. Even collective action in its simplest form—e.g., signing a petition—matters little if there is no money accompanying the message. Under subsidiarity, meaningful political participation cannot be limited to those with the financial resources to make their message heard.<sup>177</sup>

“[T]he positive dimension of subsidiarity . . . centers on making it possible for persons to exercise their freedom and on the shaping of institutions that can result in social benefit.”<sup>178</sup> Pursuant to this notion, government’s responsibility goes beyond ensuring the right to vote. The right to vote matters little if the candidates, their agendas, and voters’ decisions reflect only the views and

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POST, Mar. 15, 2001, at A4 (reporting that Bush, faced with likely congressional action, will propose increasing “federal contribution limits for individuals[,] . . . requiring advance approval for use of union dues for political activities, and eliminating ‘soft money’ contributions from corporations and unions, but not from individuals”).

175. Sarno, *supra* note 11, at 2766.

176. See, e.g., Archibald Cox, *The Case for Campaign Finance Reform*, 1 GREEN BAG 2D 289, 291 (1998) (“In many ways, the worst trouble is that people have lost their confidence in the process, lost their confidence in government, in their representatives. One study put it that people have become totally unbelieving in modern representative government, for two reasons: One, because of the flood of campaign contributions; and two, because they think the lobbyists really govern the country, and not Congress. That loss of sense of political power, and with it, and importantly, of individual political responsibility of a citizen as a citizen, is to me the most frightening thing for the country in the long run.”).

177. See Edward B. Foley, *Equal-Dollars-Per-Voter: A Constitutional Principle of Campaign Finance*, 94 COLUM. L. REV. 1204, 1204 (1994) (arguing that “wealthy citizens should not be permitted to have a greater ability to participate in the electoral process simply on account of their greater wealth”); Alvin L. Goldman, *Potential Refinements of Employment Relations Law in the 21st Century*, 3 EMPLOYEE RTS. & EMP. POL’Y J. 269, 289 (1999) (lamenting “the fact that the survival of our representative democracy continues to be threatened by campaign finance practices which place inordinate power in the hands of the tiny segment of the population that controls most of our nation’s wealth”).

178. Chmielewski, *supra* note 148, at 500.

persuasive powers of groups and individuals with enough money to make significant campaign contributions.<sup>179</sup> Further, subsidiarity's core objectives are compromised to the extent that individuals' current skepticism toward the political system renders them less likely to look beyond themselves to the greater good.<sup>180</sup> While subsidiarity does not necessarily require publicly financed campaigns or the abolition of PACs, it does, at a minimum, suggest that some government action may be necessary to ensure that individuals and the mediating groups to which they belong have a voice in the political process that is independent of their purchasing power.<sup>181</sup>

A more subtle obstacle to individuals' participation in collective decision-making arises from the manner in which the government regulates environmental matters. Subsidiarity has significant implications for environmental law,<sup>182</sup> and those implications do not fully comport with Bush's decentralizing tendencies in this area.<sup>183</sup> Two well-known implications derive from subsidiarity's requirement that the body assigned a particular function be able to carry it out effectively. First, federal action is often required because the effects of many environmentally significant activities—even if they take place entirely within a

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179. Edward Foley argues:

Voting is only the final stage of the electoral process. It is preceded not only by the agenda-formation stage (in which matters to be voted upon are identified) but also by what might be called the "argumentative stage," in which competing factions of the electorate attempt to persuade the mass of undecided voters to agree with their positions. Even if we put aside the problem of agenda formation and thus define the electoral process as commencing once the items on the ballot have been determined, we must acknowledge that a citizen does not have equal input in the electoral process if she is denied an equal opportunity to participate in the argumentative stage of the process.

Foley, *supra* note 177, at 1226-27.

180. See Cox, *supra* note 176, at 291 (linking campaign finance problems with decreased membership in voluntary associations).

181. In this sense, subsidiarity's participatory emphasis overlaps significantly with other political theories. Under Cass Sunstein's view of liberal republicanism, for example, to realize the commitment to deliberative government, citizens must build a consensus as to what constitutes a common good. See Cass R. Sunstein, *Beyond the Republican Revival*, 97 YALE L.J. 1539, 1550-51 (1988). In order to realize the commitment to political equality, all people should have an equal opportunity to deliberate in the political process.

182. See Robert W. Lannan, *Catholic Tradition, and the New Catholic Theology and Social Teaching on the Environment*, 39 CATH. LAW. 353, 380 (2000) ("In addressing environmental justice issues, Catholic bishops and theologians have relied on well-established principles of Catholic social teaching, including the common good, solidarity, subsidiarity, and an option for the poor.").

183. See, e.g., Robert Braile, *Groups Fight Rollbacks by Bush on Environment*, BOSTON GLOBE, Apr. 8, 2001, at 1 (N.H. Weekly); William Drozdiak & Eric Pianin, *U.S. Angers Allies over Climate Pact*, WASH. POST, Mar. 29, 2001, at A1; Clay Robinson, *Tax Incentives at Top of Bush's Proposals to Boost Conservation*, HOUSTON CHRON., June 2, 2000, at 28 (noting Bush's emphasis on "giving local governments and private landowners a greater voice in conservation decisions").



single state—are not necessarily limited to that state's borders.<sup>184</sup> Second, under the “race-to-the-bottom” theory, businesses will tend to be drawn to states with the least stringent environmental standards, forcing other states to choose between environmental protection and economic development.<sup>185</sup> Under this view, in order to avoid such disincentives, the primary source of environmental regulation must be the federal government.

Of greater relevance to our inquiry is the path by which the devolution of environmental decision-making to the states can, contrary to subsidiarity's mandate, disempower individuals and groups from having a meaningful voice in the public resolution of issues that matter to them. This possibility arises not merely from the “spillover” effects of regulated activities, but from the inability of state-level actors to account for the values and priorities of those outside the state when making environmental decisions. If, for example, state residents—through their elected representatives—place greater value on local logging jobs than on the preservation of wilderness areas, decentralization effectively gives them a trump over the value placed by non-residents on unspoiled wilderness. Further, the value placed by non-residents may not be measurable simply in economic terms—the fact that a Florida resident has never invested tourist dollars in Wyoming's economy on a visit to Yellowstone does not mean that he places no value on the park's preservation. While subsidiarity certainly calls for local problems to be first addressed by the communities in which they arise, it is far from obvious that the disposition of natural resources can be considered a purely local problem. Because the importance placed on natural resources is not purely a function of the state in which they happen to be found, devolving responsibility for such decisions to the state places an artificially narrow scope on subsidiarity's message of citizen empowerment.

This is not to minimize the potentially alienating consequences that the federalization of environmental decision-making in general can have on the affected communities and individuals.<sup>186</sup> It is no stretch to concede that a Wyoming resident should be given a greater voice than a Florida resident in deciding whether to develop or protect wilderness lands in Wyoming. The Florida resident, however, should not be shut out of the decision-making process completely, just as the Wyoming resident should not be cut off from weighing in on the exploration of natural gas deposits along the Florida coast. The value of this country's natural resources goes beyond the tangible economic benefits for the residents of the state in which those resources are located. It is unclear at this

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184. See, e.g., Oates, *supra* note 10, at 1329 (acknowledging that “where there are important spillover effects across state lines (as in the case of acid-rain deposition), there is a compelling case for central efforts to introduce policy measures that transcend the interests of the individual states”); cf. Silecchia, *supra* note 35, at 1183-84 (“With all due respect for subsidiarity . . . an international agreement may be the only way to tackle a complex environmental dilemma.”)

185. See, e.g., Fox, *supra* note 138, at 1790 (“[E]nvironmental law . . . is often cited as the paradigm for the race-to-the-bottom phenomenon.”).

186. See Huffman, *supra* note 10, at 31 (noting that “national regulations can be detrimental to the autonomy of local communities”).

stage whether Bush intends to resolve these issues at the national level, and merely give marginally greater weight to the opinions of local communities, or whether he plans on a more stark departure from past practice. Devolving the decision-making authority to the state level should be resisted, for it effectively shuts out non-residents from the decision, misconstruing subsidiarity's mandate in the process.

### CONCLUSION

The three principles discussed in Part IV are certainly not an exhaustive list of guidelines for subsidiarity's real-world application, nor will these principles invariably lead to a particular policy outcome when applied to a given set of facts. Antitrust, labor law, campaign finance, and environmental regulation provide examples of the distinction between subsidiarity and devolution, but even in those areas, good-faith adherents to subsidiarity will not necessarily agree on the contours of an appropriate government role. What good-faith adherents must acknowledge, however, is that subsidiarity is more complex than is suggested by its current use in today's public policy debates. Subsidiarity's devolutionary impetus, though unmistakable, must be tempered by an equal concern for the encroachment of non-government megastructures, the empowerment of mediating structures, and the facilitation of individuals' participation in societal decision-making.

Countering the one-dimensional devolutionary portrayal of subsidiarity need not render the principle meaningless, as though it could be invoked with equal legitimacy by proponents of government action and market deference in every dispute over public policy. Rather, subsidiarity stands to gain greater substance to the extent that the public can distinguish it from the preexisting agenda of either side of the political spectrum. This Article simply points out that subsidiarity, at its core, envisions a society in which problems are solved and decisions made from the bottom up. As a model of governance, subsidiarity offers no shelter to those who seek the unbridled expansion of centralized government, nor to those who disregard the need for a vital government role in making an empowered and connected citizenry a reality. Stripped of its partisan baggage, subsidiarity offers a model that—rooted in a social justice tradition that stresses both individual liberty and communitarian values—rejects the alienations of both the market and centralized government, embracing instead individuals and the mediating structures to which they belong.



# ARE THERE PROCEDURAL DEFICIENCIES IN TAX FRAUD CASES?: A REPLY TO PROFESSOR SCHOENFELD

LEANDRA LEDERMAN\*

## INTRODUCTION

Since the Senate hearings on alleged abuses by the Internal Revenue Service (IRS),<sup>1</sup> and the resulting IRS Reform Act, enacted in 1998,<sup>2</sup> scholarly attention to perceived inequities in the resolution of tax controversies has mushroomed.<sup>3</sup> For example, Professor Eric Posner has argued that the fact the IRS reform was widely supported despite the impediments it imposes to audits suggests that, in the absence of trust in the IRS, the public may not voluntarily comply with federal tax laws.<sup>4</sup>

Last year, the *Indiana Law Review* published an article entitled *A Critique of the Internal Revenue Service's Refusal to Disclose How It "Determined" a Tax Deficiency, and of the Tax Court's Acquiescence with This View* by Professor Marcus Schoenfeld (the "article").<sup>5</sup> The article argued that current law unfairly advantages the IRS in civil tax cases, particularly tax fraud cases. It reflects a particular concern that "the [IRS] combines with the Tax Court to keep the taxpayer from obtaining information about how the Service made its

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1. During three days of hearings before the Senate Finance Committee, taxpayers and IRS agents told "horror stories" about IRS treatment of taxpayers. See Wm. Brian Henning, *Reforming the IRS: The Effectiveness of the Internal Revenue Service Restructuring and Reform Act of 1998*, 82 MARQ. L. REV. 405, 405 (1999). The hearings were broadcast on television. See Ryan J. Donmoyer, *Three Days of Hearings Paint Picture of Troubled IRS*, 76 TAX NOTES 1655, 1655 (1997).

2. Internal Revenue Service Restructuring and Reform Act of 1998, 105 Pub. L. 206; 112 Stat. 685 § 1203 (1998).

3. See, e.g., Heather B. Conoboy, *A Wrong Step in the Right Direction: The National Taxpayer Advocate and the 1998 IRS Restructuring and Reform Act*, 41 WM. & MARY L. REV. 1401 (2000); Henning, *supra* note 1, at 405; Steve R. Johnson, *The Dangers of Symbolic Legislation: Perceptions and Realities of the New Burden-of-Proof Rules*, 84 IOWA L. REV. 413 (1999); Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781 (2000); Amy S. Wei, *Can Mediation Be the Answer to Taxpayers' Woes?: An Examination of the Internal Revenue Service's Mediation Program*, 15 OHIO ST. J. ON DISP. RESOL. 549 (2000).

4. See Posner, *supra* note 3, at 1812.

5. Marcus Schoenfeld, *A Critique of the Internal Revenue Service's Refusal to Disclose How It "Determined" a Tax Deficiency, and of the Tax Court's Acquiescence with This View*, 33 IND. L. REV. 517 (2000).

determination of the taxpayer's deficiency."<sup>6</sup>

Professor Schoenfeld's article provides a helpful overview of tax cases involving civil fraud, and discusses a wide array of procedural issues that arise in many of those cases. There is all too little scholarship on tax procedure,<sup>7</sup> so it is particularly rewarding to discover an additional contribution. Although I agree with Professor Schoenfeld's concern that there should be appropriate controls on the power of the IRS,<sup>8</sup> I disagree both with his suggestions for change and with some of the premises underlying those suggestions.

Professor Schoenfeld's argument, briefly stated, is that a combination of factors conspire to hinder taxpayers' defense of civil tax cases, particularly cases involving allegations of fraud.<sup>9</sup> The factors he points to span a variety of aspects of tax procedure. First, a "presumption of correctness"<sup>10</sup> attaches to the statutory notice of deficiency,<sup>11</sup> the letter from the IRS that legally asserts an underpayment in tax and is required for the United States Tax Court ("Tax Court") to take jurisdiction over a resulting lawsuit.<sup>12</sup> Second, notices of deficiency do not always adequately explain the reasons for the asserted deficiency.<sup>13</sup> Third, the Tax Court generally will not "look behind"<sup>14</sup> a notice of deficiency to see what underlies it.<sup>15</sup> Fourth, techniques allowed by the Tax Court to reconstruct unreported illegal income may "yield harsh results,"<sup>16</sup> particularly with respect to co-conspirators only marginally involved in a criminal conspiracy.<sup>17</sup> Fifth, the IRS may assert "that all of its documents are privileged,"<sup>18</sup> and therefore not available in discovery.<sup>19</sup> Sixth, the Tax Court position that IRS errors will be remedied at trial ignores the substantive importance of the notice of deficiency.<sup>20</sup> Finally, collateral estoppel generally precludes a taxpayer criminally convicted from denying facts found in the criminal trial but does not preclude a civil tax trial of a taxpayer who was acquitted criminally.<sup>21</sup> In making these points, the article also discusses related issues such as the procedures for declaring notices of deficiency involving

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6. *Id.* at 569.

7. Steve Johnson, *A Residual Damages Right Against the IRS: A Cure Worse than the Disease*, 88 TAX NOTES 395, 395 (2000).

8. See Schoenfeld, *supra* note 5, at 568.

9. *Id.* at 517.

10. *Id.*

11. *Id.*

12. See I.R.C. §§ 6212(a), 6213(a) (Supp. 1999).

13. Schoenfeld, *supra* note 5, at 517.

14. *Id.* at 524.

15. *Id.* at 524-25.

16. *Id.* at 518.

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.* at 549.



unreported income “arbitrary and erroneous.”<sup>22</sup>

Tax controversy procedure, like civil litigation procedure generally, reflects a balancing of interests of plaintiff and defendant. In tax controversies, the parties are the IRS and the taxpayer. In general, the procedural rules seek to provide a level playing field, place the burden of producing information on the party in possession of that information, and encourage settlement. Professor Schoenfeld’s criticism of the IRS and the Tax Court should be considered in that context. That is, to what extent are the burdens he discusses unfairly targeted at taxpayers, and to what extent do they reflect only one side of an even-handed balancing act?

Professor Schoenfeld’s concerns, listed above, logically fall into two general categories: taxpayer access to IRS information and IRS techniques for proving tax fraud. Accordingly, this reply has two principal parts. Part I disputes Professor Schoenfeld’s contentions that the IRS’s approach, coupled with the Tax Court’s rules, hampers taxpayers’ abilities to obtain appropriate information to defend tax deficiency and tax fraud suits. Section A briefly outlines basic tax controversy procedure. Section B focuses on notices of deficiency. It discusses their importance and the multiple roles they play in tax controversies, and it specifically considers the “presumption of correctness” as well as uninformative, inaccurate, and arbitrary notices. Section C of Part I explores procedures for obtaining the report of the IRS revenue agent.

Part II of this reply analyzes the IRS’s methods of proving tax fraud, focusing on the areas Professor Schoenfeld finds particularly objectionable: collateral estoppel, the use of badges of fraud, and IRS-protective positions. Section A of this Part analyzes the use of collateral estoppel and badges of fraud in the context of the IRS’s burden of proving fraud by clear and convincing evidence. This section argues that these methods are appropriate means for the IRS to use to try to meet that burden. Section B of Part II focuses on IRS-protective positions, which address a materially different aspect of any fraud case: the amount of the deficiency. Once fraud is proven by the IRS, it is the *taxpayer* who bears the burden of proving the amount of the deficiency that is *not* attributable to fraud. Section B focuses on the problems that this procedural posture causes while refuting some of Professor Schoenfeld’s objections to IRS-protective positions.

## I. OBTAINING INFORMATION FROM THE IRS IN CIVIL TAX CONTROVERSIES

### A. *Basic Tax Controversy Procedure*

As Professor Schoenfeld explains, civil tax cases generally begin with a disagreement between the taxpayer and the IRS over the tax owed by the taxpayer.<sup>23</sup> If the disagreement began with a refund claim filed by the taxpayer, the IRS manifests its disagreement with a “notice of disallowance.” In other cases, an unresolved dispute generally results in IRS issuance of a “notice of

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22. See *id.* at 539-40.

23. *Id.* at 520.

deficiency," the letter mentioned previously that alerts the taxpayer to the amount of the alleged deficiency (underpayment of tax). The notice may also contain additions to tax for such things as late filing of the return, negligence, or fraud. It generally also provides an explanation of the deficiency and additions to tax.

Except where collection of the tax is in jeopardy,<sup>24</sup> the IRS generally is required by statute to mail the taxpayer a notice of deficiency prior to assessment.<sup>25</sup> "Assessment" is formal recording by the IRS of the taxpayer's tax liability.<sup>26</sup> Assessment is a legal prerequisite to the IRS's administrative collection procedures. The notice of deficiency therefore is central to tax controversies.

The notice of deficiency also provides the taxpayer with a "ticket to the Tax Court"; Tax Court subject-matter jurisdiction over tax deficiency cases requires both a notice of deficiency and a timely responsive petition (generally one that is filed within ninety days of the date the notice of deficiency was mailed).<sup>27</sup> The IRS is required to file an answer.<sup>28</sup> Those documents form the pleadings in Tax Court litigation; additional pleadings may be made in the form of amendments and a reply when required.<sup>29</sup> In civil fraud cases, the IRS bears the burden of persuasion by "clear and convincing evidence."<sup>30</sup>

### *B. The Notice of Deficiency*

Exchange of information between the IRS and the taxpayer typically begins with the audit. In most tax controversies, after the audit, the IRS will send the taxpayer a preliminary notice of deficiency, commonly known as a thirty-day letter. The thirty-day letter is the cover letter accompanying the IRS revenue agent's report. It provides an opportunity for the taxpayer to obtain an administrative appeal by responding within thirty days.<sup>31</sup> Informal communications, the revenue agent's report, the appeals conference, and other settlement efforts are all sources of information about the IRS's case.

If a tax controversy remains unresolved when the statute of limitations nears

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24. I.R.C. § 6861(a) (1994).

25. *Id.* § 6212(a) (Supp. V 1999) ("If the Secretary [of the Treasury] determines that there is a deficiency in respect of any tax imposed by [certain subtitles and chapters of the Code] he is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail."). The authorization language apparently refers to the method of delivery; the notice itself is not optional. *See id.* § 6213(a) (subject to certain exceptions, "no assessment of a deficiency in respect of any tax imposed by [certain subtitles and chapters] and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer").

26. *See* LEANDRA LEDERMAN & STEPHEN W. MAZZA, *TAX CONTROVERSIES: PRACTICE AND PROCEDURE* 8 (2000).

27. I.R.C. § 6213(a) (1994).

28. TAX CT. R. PRAC. & P. 30; *see also id.* at 36.

29. *See id.* at 30, 37, 41.

30. *Id.* at 142(b); *see also* I.R.C. § 7454(a) (1994).

31. *See* LEDERMAN & MAZZA, *supra* note 26, at 9.



expiration, the IRS will send the taxpayer a notice of deficiency. The notice of deficiency is the first official, required notice to the taxpayer of the IRS's assertion of a tax underpayment. As discussed above, the taxpayer may be well-served in the IRS's case at the point he receives a notice of deficiency. Nonetheless, the notice of deficiency provides official notice of the deficiency amount and the IRS's reason for the adjustment.

Mailing of a notice of deficiency has multiple, important consequences. First, the notice of deficiency provides notice to the taxpayer of the asserted deficiency and of the IRS's intent to assess if the taxpayer does not respond by filing a timely Tax Court petition (a notification function). Second, the notice provides the taxpayer with the jurisdictional "ticket to the Tax Court," as discussed above. Third, assessment of tax is prohibited during the ninety-day period within which the taxpayer may petition the Tax Court, and if a Tax Court petition is filed, until the Tax Court decision is final. Fourth, as a corollary, the notice tolls the statute of limitations on assessment for the length of the prohibited period plus sixty days, providing the IRS with time to assess tax should the taxpayer lose the Tax Court case or fail to petition the Tax Court. Fifth, if the taxpayer does petition the Tax Court, the notice of deficiency becomes part of the pleadings, in effect forming the first statement of the IRS's case, analogous to a complaint. Finally, in Tax Court, the notice of deficiency plays an important role in allocating the burden of proof.<sup>32</sup>

A notice of deficiency that is defective such that it is invalid is void *ab initio* so that, generally speaking, it plays none of these functions.<sup>33</sup> The immediate effect of a Tax Court determination that a notice is invalid is that the Tax Court will dismiss the case for lack of subject-matter jurisdiction. A key collateral consequence is that an invalid notice does not toll the statute of limitations on assessment, so the period for assessment ordinarily will have expired.<sup>34</sup> Expiration of the statute of limitations precludes assessment and collection of tax by the IRS.

Professor Schoenfeld accurately points out that, in considering arguably defective notices of deficiency, the Tax Court has overemphasized the jurisdictional function of the notice of deficiency.<sup>35</sup> I have previously argued that not all defects in notices of deficiency are grounds for invalidation and

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32. The notice of deficiency therefore has three main functions and several lesser functions. The three main functions are the notice function, the pleading function in a Tax Court case, and the jurisdictional function in Tax Court. Confusing these functions may result in inappropriate remedies for defective notices, particularly inappropriate dismissals for lack of Tax Court subject-matter jurisdiction. See generally Leandra Lederman, "Civilizing Tax Procedure: Applying General Federal Learning to Statutory Notices of Deficiency, 30 U.C. DAVIS L. REV. 183 (1996).

33. Cf. *Roszkos v. Comm'r*, 850 F.2d 514, 517 (9th Cir. 1988) (stating that notices of deficiency sent to incorrect addresses were "null and void").

34. See, e.g., *Reddock v. Comm'r*, 72 T.C. 21, 26 (1979); *Atlas Oil & Ref. Corp. v. Comm'r*, 22 T.C. 552, 558-59 (1954), *overruled on other grounds by* *Woods v. Comm'r*, 92 T.C. 776, 778 (1989).

35. See Schoenfeld, *supra* note 5, at 534.

concomitant dismissal of the Tax Court case.<sup>36</sup> Instead, the Tax Court should consider whether a defect affects the notification or pleading function or is truly *jurisdictional*.<sup>37</sup> In fact, a notice of deficiency needs far fewer elements to allow the Tax Court to take jurisdiction over the case than it does to notify a taxpayer in enough detail to enable the taxpayer to rebut IRS allegations in his principal Tax Court pleading, the petition.<sup>38</sup>

1. *The "Presumption of Correctness."*—As Professor Schoenfeld points out, a "presumption of correctness" is afforded the notice of deficiency.<sup>39</sup> This term is somewhat misleading. Professor Schoenfeld argues that "the Notice [of deficiency] . . . carries substantive weight because it is presumed to be correct."<sup>40</sup> However, the presumption of correctness is not a true presumption; it carries no more evidentiary weight than does the "presumption of innocence" of a criminal defendant. The presumption of correctness merely serves to assign the burden of going forward.<sup>41</sup> That is, by affording the notice of deficiency initial credence, the taxpayer must come forward in any Tax Court case with evidence to counter it, rather than the IRS first submitting additional documents.<sup>42</sup>

There are two main rationales for the presumption of correctness. First, it is the taxpayer who has the evidence supporting the entries on his tax return.<sup>43</sup> Second, in the usual case, the IRS follows a businesslike routine that will be effective in the vast majority of cases. In fact, many audits end at the administrative level before a notice of deficiency is ever prepared. If the IRS has concluded its administrative process through issuance of the notice, the presumption of administrative regularity justifies placing the initial burden in litigation on the taxpayer.<sup>44</sup>

There are two important exceptions to the usual case in which the notice of deficiency provides a basis for placing the burden of going forward on the taxpayer, one of which, "arbitrary and erroneous" notices, was discussed by

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36. See Lederman, *supra* note 32, at 238.

37. See *id.*

38. Learned Hand famously stated that "the notice is only to advise the person who is to pay the deficiency that the Commissioner means to assess him; anything that does this unequivocally is good enough." *Olsen v. Helvering*, 88 F.2d 650, 651 (2d Cir. 1937).

39. Schoenfeld, *supra* note 5, at 517.

40. *Id.* at 518 (emphasis added).

41. See, e.g., *United States v. Janis*, 428 U.S. 433, 441 (1976); *Portillo v. Comm'r*, 932 F.2d 1128, 1133 (5th Cir. 1991); *Anastasato v. Comm'r*, 794 F.2d 884, 886 (3d Cir. 1986); cf. *DiMauro v. United States*, 706 F.2d 882, 884 (8th Cir. 1983) (in wagering excise tax case, government must come forward with evidence connecting taxpayer to wagering before presumption applies).

42. See *Anastasato*, 794 F.2d at 887. "The presumption of correctness establishes a *prima facie* case, but it arises only if supported by foundational evidence connecting the taxpayer with the tax-generating activity." *Id.* (emphasis added).

43. Sean M. Moran, *The Presumption of Correctness: Should the Commissioner Be Required to Carry the Initial Burden of Production*, 55 *FORDHAM L. REV.* 1087, 1100 (1987).

44. See Lederman, *supra* note 32, at 201 n.97.



Professor Schoenfeld. In *Janis v. United States*,<sup>45</sup> the United States Supreme Court termed an arbitrary assessment a “‘naked’ assessment without any foundation whatsoever.”<sup>46</sup> The line of cases addressing arbitrary and erroneous notices reflects the understanding that, in cases involving unreported income, the rationale that the taxpayer possesses the evidence breaks down. As many courts have noted, it is difficult, if not impossible, to prove a negative (that is, nonreceipt of income). Thus, in unreported income cases, particularly those involving income allegedly received from illegal or illicit sources,<sup>47</sup> if a taxpayer alleges that the notice was arbitrary and erroneous, the burden of going forward shifts back to the IRS to support the notice.<sup>48</sup>

In *Ryan v. Commissioner*,<sup>49</sup> a case that influenced Professor Schoenfeld’s article,<sup>50</sup> the Tax Court stated it this way:

As we review each of [the IRS’s] assertions concerning each respective search [by the police officer petitioners], we consider whether respondent has presented predicate evidence linking the specific petitioner to the tax-generating activity from which respondent asserts income has arisen for such petitioner. Where there is no such predicate evidence, we attribute no income to that petitioner.<sup>51</sup>

When the IRS is able to tie the taxpayer to the illegal or illicit income-generating activity, the IRS has met its burden, and the burden then shifts back to the taxpayer. Faced with the allegation of a source of the income, the taxpayer is then empowered to provide some defense to the allegation.

In several cases, taxpayers have been successful in shifting the burden to the IRS based on an allegation that the notice of deficiency was arbitrary and erroneous. Some of those cases were won on motion by the taxpayer because the IRS could not come up with evidence supporting the notice.<sup>52</sup> Admittedly, those cases suggest administrative failure that burdened the taxpayer. However, prevailing taxpayers are entitled to sue for administrative costs and litigation

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45. 428 U.S. 433 (1976).

46. *Id.* at 441.

47. “Most of the cases stating that the Commissioner is not entitled to the presumption [of correctness] based on a naked assessment without factual foundation have involved illegal income.” *Anastasato*, 794 F.2d at 887. *Anastasato* involved the receipt of illicit “override” commissions by a travel agent. *See id.* at 885. It is particularly hard to disprove the receipt of income that a recipient would generally have received secretly.

48. *Cf. Gerardo v. Comm’r*, 552 F.2d 549, 554 (3d Cir. 1977) (stating that in case of unreported illegal income, the IRS must present “some predicate evidence connecting the taxpayer to the charged activity.”).

49. 75 T.C.M. (CCH) 1778 (1998).

50. *See* Schoenfeld, *supra* note 5, at 517 n.\*. (“The opinions of the author are largely based [sic] and are augmented by . . . *Ryan*.”).

51. *Ryan*, 75 T.C.M. (CCH) at 1777-78.

52. *See, e.g., Portillo v. Comm’r*, 932 F.2d 1128, 1130 (5th Cir. 1991).

fees.<sup>53</sup> Those costs and fees may be awarded if the IRS pursued a frivolous position, the taxpayer exhausted any administrative remedies afforded by the IRS, and the taxpayer meets a net worth requirement.<sup>54</sup>

An exception to the usual burden of proof procedure was statutorily created in 1998. Code section 7491 provides the taxpayer with the opportunity to shift the burden of proof to the IRS, if he meets several requirements. Because, in order to do so, the taxpayer is required to make an initial presentation of "credible evidence" with respect to the factual issue,<sup>55</sup> it is most accurate to say that section 7491 places the burden of going forward on the taxpayer, though it allows a shift in the burden of persuasion. As noted by numerous commentators,<sup>56</sup> section 7491 is likely to be of little practical use. In addition, the IRS already bears the burden of proving fraud. However, it is important to note that the content of section 7491, with its "credible evidence" requirement,<sup>57</sup> suggests continuing cognizance of the practical reality that the taxpayer is the one with evidence supporting the entries on the tax return, just as the presumption of correctness does.

Thus, the so-called presumption of correctness, though unfortunately implying a degree of deference to the IRS, in fact serves the salutary purpose of allocating the burden of going forward to the party in possession of the evidence relating to the controversy. Even the workings of section 7491 reflect this notion. Where the presumption would allocate the burden of going forward to a party without evidence, because it alleges receipt of illicit income, case law

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53. See I.R.C. § 7430 (1994).

54. See *id.*

55. I.R.C. § 7491(a)(1) (Supp. V 1999).

56. See, e.g., Johnson, *supra* note 3, at 413 (Code section 7491 "is a pernicious exercise in symbolic legislation."); Anthony F. Newton, *The 'Stat' Notice in the New Millennium: Shouldn't the Notice Be User Friendly?*, 91 TAX NOTES 1139, 1157 (2001) ("Congress did make a feeble attempt to level the playing field with the addition of section 7491. However, its effect has not yet been realized and, due to its limitations, more likely than not, it never will be."); see also Higbee v. Comm'r, 116 T.C. 438 (2001).

Because [the taxpayers] have failed to provide credible evidence of a casualty loss, the burden of proof as to this issue is not placed on [the IRS]. Further, for similar reasons regarding our discussion of [the taxpayers'] evidence for purposes of section 7491, we conclude that [the taxpayers] have not met their burden of proof.

*Id.* at 443; cf. Nathan E. Clukey, *Examining the Limited Benefits of Shifting the Burden of Proof to the IRS*, 82 TAX NOTES 683 (1999).

This article . . . posits that . . . an expansive reading of credible evidence must be rejected, and that once that is done, the statute will have a noticeable effect in regard to evidence not governed by heightened substantiation requirements—by giving the taxpayer a strategic advantage compared to prior law. However, it acknowledges that where the heightened substantiation requirements are applicable, this strategic advantage will be eviscerated.

*Id.* at 685.

57. *Id.* at 688.



provides a mechanism for shifting that burden to the IRS.

2. *Inaccurate, Arbitrary, and Uninformative Notices of Deficiency*.—One of Professor Schoenfeld's major complaints is the rule of *Greenberg's Express, Inc. v. Commissioner*.<sup>58</sup> In *Greenberg's Express*, the Tax Court held that it would not "look behind a deficiency notice to examine the evidence used or the propriety of [the IRS's] motives or of the administrative policy or procedure involved in making [the] determinations."<sup>59</sup> The court reasoned that the Tax Court trial is a *de novo* proceeding in which the administrative record is irrelevant.<sup>60</sup> In effect, the court seemed to be stating that it would not invalidate the notice because of the process that generated it, even if that process might be defective. Professor Schoenfeld makes the excellent point that the facts of *Greenberg's Express* involved the issue of whether the IRS had chosen to audit certain taxpayers for an impermissible reason, not if the audit process itself was careless or otherwise defective. He argues that "*Greenberg's Express* is of little pertinence to an inquiry into *how* (not *why*) a revenue agent may have committed errors in preparing his determination of the assertions set out in the Statutory Notice."<sup>61</sup>

Although this analysis might imply that the holding of *Greenberg's Express* should be limited to cases involving IRS selection of which returns to audit, there is still value in treating the notice of deficiency as a pleading that the Tax Court does not look behind. Essentially, the notice makes allegations of fact that the taxpayer has the option to dispute in court.<sup>62</sup> If there are mistakes in the notice of deficiency, the taxpayer should have the evidence necessary to correct them unless they arrive out of an arbitrary and erroneous notice, which the taxpayer is empowered to counter procedurally, as discussed above. Analyzing the process used to generate the notice would distract from analysis of the substantive issues in the case.

Professor Schoenfeld posits that "[a]pplying *Greenberg's Express* as the Service argues would shield almost all information that might tend to show that an employee of the Service acted improperly or carelessly."<sup>63</sup> However, the *Greenberg's Express* court did state that it would shift the burden of going

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58. 62 T.C. 324 (1974).

59. *Id.* at 327.

60. *Id.* at 328.

61. Schoenfeld, *supra* note 5, at 528 (emphasis in original).

62. If the taxpayer never receives the notice or fails to petition the Tax Court in a timely manner, he will still have an opportunity to litigate, post-assessment. Two fora will be available to the taxpayer: the United States District Courts and the United States Court of Federal Claims. See 28 U.S.C. §§ 1346(a)(1), 1491(a)(1) (1994). Following assessment, the taxpayer will be required to pay the tax. Following payment, a taxpayer who wishes to contest the tax liability must file a refund claim as a prerequisite to suit. I.R.C. § 7422(a) (1994). Upon disallowance of the claim, waiver of disallowance by the taxpayer, or passage of six months, the taxpayer may file suit in either of the refund fora listed above. See *id.* § 6532(a)(1). Unfortunately, the "full payment" rule does provide a barrier to accessing those fora. See *Flora v. United States*, 362 U.S. 145 (1960).

63. Schoenfeld, *supra* note 5, at 529.

forward to the IRS if a taxpayer presented substantial evidence of unconstitutional conduct by the IRS.<sup>64</sup> Professor Schoenfeld makes this point quite clearly: "[T]he Tax Court did not say that it would *never* look behind the Statutory Notice. On the contrary, the court said it would do so, particularly when there was substantial evidence of unconstitutional behavior on the part of the Service's employees in preparing the Statutory Notice."<sup>65</sup> He points out that, in that instance, "the Statutory Notice would no longer carry the presumption of correctness that is normally conferred upon it."<sup>66</sup> In other words, the Tax Court would shift the burden of going forward to the IRS.

*a. Inaccurate notices.*—Professor Schoenfeld used *Scar v. Commissioner*<sup>67</sup> as "[a]n extreme example of the Tax Court's persistent refusal to look behind a Statutory Notice."<sup>68</sup> *Scar* is extreme; its facts are highly unusual and unrepresentative of the overwhelming majority of statutory notices. However, *Scar* has little relevance to Tax Court reluctance to examine the pre-notice of deficiency administrative process at the IRS. Instead, *Scar* is a case about the proper remedy for an inaccurate notice of deficiency.

As Professor Schoenfeld relates in his article, the notice of deficiency in *Scar* asserted a deficiency of \$96,600 based on the disallowance of deductions attributable to the "Nevada Mining Project,"<sup>69</sup> a tax shelter in which the Scars had never invested. The notice calculated the deficiency by applying the maximum marginal rate of seventy percent to \$138,000 of disallowed deductions. An attachment explained, "In order to protect the government's interest and since your original income tax return is unavailable at this time, the income tax is being assessed at the maximum tax rate of 70%."<sup>70</sup>

The Scars' Tax Court petition denied that they had ever had any interest in the Nevada Mining Project. The IRS's answer denied the allegations of the petition in full. The Scars moved to dismiss for lack of jurisdiction. In response, the IRS conceded that the Scars had never had any interest in Nevada Mining, and moved for leave to amend its answer, to state a decreased deficiency attributable to Executive Productions, Inc., a videotape tax shelter.<sup>71</sup>

In court, the IRS explained that the error in the notice had occurred because one of its agents had transposed numbers when entering the code assigned to the videotape tax shelter.<sup>72</sup> The *Scar* case reflects a degree of sloppiness rarely seen. As is evident from the case, the tax shelter era of the 1980s produced a

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64. 62 T.C. at 328.

65. Schoenfeld, *supra* note 5, at 527-28 (emphasis in original) (footnotes omitted).

66. *Id.* at 528.

67. 81 T.C. 855 (1983), *rev'd*, 814 F.2d 1363 (9th Cir. 1987).

68. Schoenfeld, *supra* note 5, at 531.

69. *Scar v. Comm'r*, 814 F.2d 1363, 1365 (9th Cir. 1987), *rev'g* 81 T.C. 855 (1983).

70. *Id.* This aspect of the case is discussed below. See *infra* notes 81-83 and accompanying text.

71. 814 F.2d at 1365-66.

72. *Id.* at 1365.



voluminous caseload for the IRS.<sup>73</sup>

The main issue decided in *Scar*, which went up to the Court of Appeals for the Ninth Circuit, was whether the faulty notice of deficiency was “invalid” and therefore required dismissal for lack of Tax Court subject-matter jurisdiction.<sup>74</sup> The Ninth Circuit reversed the Tax Court’s ruling that the notice was valid, holding that the notice had failed to make the “determination” required by section 6212(a).<sup>75</sup> Professor Schoenfeld praises the outcome in *Scar*, stating:

The view of the Ninth Circuit in *Scar* seems correct. There really should be a “determination” as prescribed in the statute and the Service’s published internal procedures, and then those determinations of fact and law should be spelled out in the Notice. This is necessary to permit fairness in litigation. The Statutory Notice not only confers jurisdiction on the Tax Court, in practical effect it is really also the initial pleading in the case.<sup>76</sup>

Although Professor Schoenfeld is correct that the notice of deficiency serves a pleading function once a taxpayer invokes the Tax Court’s jurisdiction by filing a petition, and although notices of deficiency should specify their determinations, as the Code requires,<sup>77</sup> that does not mean *Scar* was correctly decided. In fact, what *Scar* did was turn a defect in a pleading function (framing the litigation) into a *jurisdictional* objection. As discussed previously, much less is required to get a case before a court than to make one’s case to the court. In *Scar*, the notice of deficiency met minimum jurisdictional standards: it contained the Scars’ names and address, the correct tax year, a deficiency amount, and a statement explaining how the deficiency was calculated.<sup>78</sup>

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73. That volume is evidenced in part by the inventory of the Tax Court. IRS data reflects that in 1981, the Tax Court had about 38,000 docketed cases, with about seventeen percent of those tax shelter cases, while in 1984, the Tax Court had about 43,000 docketed cases, thirty-three percent of which were tax shelter cases. See U.S. TAX COURT JUDICIAL CONFERENCE, CHIEF COUNSEL FOR THE INTERNAL REVENUE SERVICE, OCTOBER 1986, at 1. According to the Tax Court, in fiscal year 1984, 42,024 cases were filed and 63,598 were pending. See UNITED STATES TAX COURT, 1990 FISCAL YEAR STATISTICAL INFORMATION (1991). By contrast, in fiscal year 2000, only 16,572 cases were pending in the Tax Court, and fewer than eleven percent of those were tax shelter cases. See OFFICE OF CHIEF COUNSEL, INTERNAL REVENUE SERVICE, AMERICAN BAR ASSOCIATION TAX SECTION COURT PROCEDURE COMMITTEE 11 (2001). *Scar* was decided in 1983, during a spurt in tax shelter litigation.

74. 814 F.2d at 1365.

75. See *id.* at 1370.

76. Schoenfeld, *supra* note 5, at 534.

77. See I.R.C. § 7522 (1994). Section 7522 is discussed in more detail later. See *infra* text accompanying notes 100-11.

78. Cf. *Scar*, 814 F.2d at 1370 n.11 (“In the case before us the Commissioner argues that, because the notice contained the Taxpayers’ names, social security number, the tax year in question, and ‘the’ amount of deficiency, it was ‘clearly sufficient.’”); *Olsen v. Helvering*, 88 F.2d 650, 651 (2d Cir. 1937) (holding that anything that communicates IRS’s intent to assess suffices); *Donohue*

The *Scar* notice nevertheless is highly problematic. Judge Hall, the former Tax Court judge who dissented in *Scar*, stated that a notice of deficiency is "nothing more than 'a jurisdictional prerequisite to a taxpayer's suit seeking the Tax Court's redetermination of [the IRS's] determination of the tax liability.'"<sup>79</sup> That is an overstatement; it does not account for the pleading function of the notice. As I have previously argued, "The egregious content errors in the Scars' statutory notice are troublesome but are not jurisdictional. The content errors in the *Scar* notice should instead have been corrected during the litigation."<sup>80</sup> Once the *Scar* answer was amended, it would have asserted "new matter" not raised in the notice of deficiency, which would place the burden of proof on those issues on the IRS.<sup>81</sup> In fact, even if the IRS had not moved to amend its answer, the Scars could have moved to have the burden shifted to the IRS under Tax Court Rule 142(a) on the issues relating to the videotape tax shelter.

Thus, *Scar* involved an erroneous notice of deficiency. The Ninth Circuit's decision to invalidate the notice did not require "looking behind" it to evidence regarding the IRS's administrative process. Instead the court found that information on the face of the notice warranted the court's concern. Unfortunately, the court chose the wrong remedy: it simply should have shifted the burden of going forward to the IRS, rather than invalidating the notice and therefore dismissing the case.

*b. Arbitrary notices.*—One issue in *Scar* was the apparent arbitrariness of the IRS's "determination," because the Scars' original return was unavailable. At first blush, it may appear impossible for the IRS to make a determination of tax liability without the taxpayer's return. However, the IRS codes data from each tax return.<sup>82</sup> The IRS's position, supported by case law,<sup>83</sup> is that the IRS

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v. Comm'r, 37 T.C.M. (CCH) 954, 954-56 (1978) (holding that mutilated notice containing no date, address, year or deficiency amount was sufficient for Tax Court subject-matter jurisdiction).

79. 814 F.2d at 1372 (Hall, J., dissenting) (quoting *Stamm Int'l Corp. v. Comm'r*, 84 T.C. 248, 252 (1985)). Subsequent decisions, even in the Ninth Circuit, have limited *Scar* to its facts. See, e.g., *Clapp v. Comm'r*, 875 F.2d 1396, 1402 (9th Cir. 1989) ("Only where the notice of deficiency reveals on its face that the Commissioner failed to make a determination is the Commissioner required to prove that he did in fact make a determination."); *Campbell v. Comm'r*, 90 T.C. 110 (1988).

Where the alleged notice of deficiency reveals on its face that [the IRS] failed to make a determination, then the Ninth Circuit would require respondent to prove that he did make a determination. Here the 9-page document does not reveal on its face that [the IRS] failed to make a determination.

*Id.* at 114.

80. Lederman, *supra* note 32, at 238.

81. See TAX CT. R. PRAC. & P. 142(a).

82. See *Scar*, 814 F.2d at 1374 n.4, stating:

Although the "unavailability" of the Scars' return may indicate that the Scars' original paper return was not before the Commissioner, it does not show that specific data on that return or relation to the video-tape tax shelter was not considered. Due to the computerization of the IRS, the Commissioner no longer operates from original paper



“may rely on taxpayer return information duly recorded in the Service’s official records and data bases”<sup>84</sup> because a requirement that the IRS rely only on the original paper return would inhibit the IRS’s efforts to computerize.<sup>85</sup> Computerization generally makes the IRS’s processes both quicker and less costly.<sup>86</sup>

Another concern expressed in *Scar* is the hypothetical of an IRS run amok, sending out notices of deficiency willy-nilly. The Ninth Circuit reproduced from Judge Sterrett’s dissent in the Tax Court an invented, tongue-in-cheek notice that reflects this fear. In part, it states:

Dear Taxpayer: There is a rumor afoot that you were a participant in the Amalgamated Hairpin Partnership during the year 1980. Due to the press of work we have been unable to investigate the accuracy of the rumor or to determine whether you filed a tax return for that year.<sup>87</sup>

It seems unlikely that the IRS would send out notices based on mere rumor or worse, invidious discrimination against certain taxpayers.<sup>88</sup> In fact,

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returns.

*Id.* (Hall, J., dissenting); *Whittington v. Comm’r*, 78 T.C.M. (CCH) 339 (1999) (IRS used Returns Transaction Data System (RTVUE), a line-by-line transcript of taxpayer’s return, in arriving at its deficiency determination).

83. *See, e.g.*, *Griner v. Comm’r*, 1991 U.S. App. LEXIS 30021 (9th Cir. 1991) (“Griner’s argument that the determination was invalid because the Commissioner may not have used the original papers filed by the Griners is without merit. Whether the Commissioner used the originals, copies, or computer reports of the returns is not important.”); *Whittington v. Comm’r*, 78 T.C.M. (CCH) 339 (1999) (upholding IRS use of RTVUE transcript of taxpayer’s return to arrive at deficiency determination).

84. IRS FSA 200004017, 1999 FSA LEXIS 291, \*9.

85. *Id.* However, in a Tax Court case, appealable to the Ninth Circuit, in which the IRS did not actually use the transcript of the return that was in its files, and simply computed the tax at the top marginal rate, the IRS found the notice of deficiency invalid under the reasoning of *Scar*. *See Kong v. Comm’r*, 60 T.C.M. (CCH) 696 (1990); *see also Toll v. Comm’r*, 1991 U.S. App. LEXIS 17529 (9th Cir. 1991) (similar holding by the Ninth Circuit, on similar facts); *Carnahan v. Comm’r*, 61 T.C.M. (CCH) 2406, 2407-08 (1991) (prior docket in the case was dismissed because it was based on notice of deficiency that stated “[i]n order to protect the government’s interest and since your original income tax return is unavailable at this time, the income tax is being assessed at the maximum tax rate of 70%.”).

86. For example, in 1993, the IRS estimated that its use of the RTVUE system would save \$1.2 million dollars, and would enable the IRS to provide taxpayers with transcripts of their accounts within twenty-four to forty-eight hours of a request, as opposed to the six to eight weeks required to obtain a copy of a tax return. *See Fact Sheet FS-93-3*, 1993 IRB LEXIS 394.

87. *Scar*, 814 F.2d 1363, 1370 n.12 (9th Cir. 1987) (quoting *Scar v. Comm’r*, 81 T.C. 855, 869 (1983) (Sterrett, J., dissenting)).

88. In a Litigation Guideline Memorandum issued by the IRS to its personnel shortly after *Scar* was decided, and released in 2000 under the Freedom of Information Act, the IRS stated, in part:

investigation of the “abuses” alleged at the IRS hearings—most of which were concentrated in the collections area<sup>89</sup>—suggests that many of them were unfounded.<sup>90</sup> In addition, the Code provides criminal penalties for unauthorized inspection of return information by IRS employees.<sup>91</sup> Furthermore, the Internal Revenue Service Restructuring and Reform Act of 1998 included a provision known as the “Ten Deadly Sins,” commission of which requires termination of the IRS employee.<sup>92</sup> The “sins” include “violations of the Internal Revenue Code of 1986, Department of Treasury regulations, or policies of the Internal Revenue Service (including the Internal Revenue Manual) for the purpose of retaliating against, or harassing, a taxpayer, [or] taxpayer representative,”<sup>93</sup> as well as “threatening to audit a taxpayer for the purpose of extracting personal gain or benefit.”<sup>94</sup>

Taxpayers also have tools to contest arbitrary or unfounded notices of deficiency. First, the Tax Court provides a forum for taxpayers to contest notices of deficiency without first paying the deficiency asserted. In addition, an undocumented notice alleging unreported income would be arbitrary and erroneous, which, on the taxpayer’s motion, would result in a shift to the IRS of the burden of going forward, unless the IRS were able to tie the taxpayer to the tax-generating activity. In the case of an arbitrary notice denying a deduction, credit, or exclusion, the taxpayer should have the evidence to rebut the IRS’s contention. Furthermore, as discussed above, Code section 7430 allows a court to award a prevailing taxpayer reasonable litigation and administrative costs if the IRS’s position was not substantially justified and the taxpayer “has exhausted the administrative remedies available”<sup>95</sup> to him within the IRS.<sup>96</sup>

Section 7430, which requires that the taxpayer substantially prevail, will not protect a taxpayer who loses on the merits after a successful “fishing expedition”

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Notwithstanding our legal view that the Ninth Circuit panel majority was incorrect in its legal analysis of the jurisdiction of the Tax Court and our commitment to defend the jurisdiction as noted above, the process the Service used in *Scar* is rightly condemned. The Office of Chief Counsel has expressed to the Examination Division its strong objections to the procedure of issuing inadequate notices to “protect the government’s interest.” Steps are being taken to prevent a repeat of the situation exemplified by *Scar*. All attorneys in the Office of Chief Counsel should be aware of this and take necessary steps to forestall further *Scar* situations.

LGM TL-3 (Jan. 15, 1988), 2000 TNT 121-89.

89. See George Guttman, *Public Relations: The IRS Could Do a Lot More to Help Its Image*, 87 TAX NOTES 479, 480 (2000).

90. Ryan J. Donmoyer, *Horror Story Heard by Senate Panel Was Half-Told Tale*, 79 TAX NOTES 518, 520 (1998).

91. See I.R.C. § 7213A (Supp. V 1999).

92. H.R. 2676, 105th Cong. § 1203 (1998).

93. *Id.* at § 1203(b)(6)-(10).

94. *Id.*

95. I.R.C. § 7430(b)(1) (1994).

96. *Id.* § 7430.



by the IRS. However, Tax Court rules require parties or their attorneys to sign their pleadings,<sup>97</sup> and they contain sanctions similar to Rule 11 of the Federal Rules of Civil Procedure for pleadings filed for improper purposes:

The signature of counsel or a party constitutes a certificate by the signer that . . . to the best of the signer's knowledge, information, and belief formed after reasonable inquiry, it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and *that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation*. . . . If a pleading is signed in violation of this Rule, the Court, upon motion or upon its own initiative, may impose upon the person who signed it, a represented party, or both, an appropriate sanction, which may include an order to pay to the other party or parties the amount of the reasonable expenses incurred because of the filing of the pleading, including reasonable counsel's fees.<sup>98</sup>

This provision provides a sanction for the hypothetical circumstance in which IRS pleadings were made in order to perpetuate a case premised on harassing the taxpayer.

c. *Uninformative notices*.—Professor Schoenfeld also expresses concern about specificity in notices of deficiency, arguing that

[a]pplying *Greenberg's Express* as the Service argues would shield almost all information that might tend to show that an employee of the Service acted improperly or carelessly. Except for the most blatant and erroneous situations, such as an obvious and substantial mathematical error on the face of the Statutory Notice, or a Notice which clearly does not refer to the petitioner's income or deductions, a petitioner must know how the specific dollar assertions in the Statutory Notice were computed in order to begin to bear his burden of refuting the assertions.<sup>99</sup>

It is certainly true that the taxpayer must know how the dollar amounts in the notice were determined in order to produce appropriate evidence to contradict the determination. However, *Greenberg's Express* does not prevent specificity in notices of deficiency. On the contrary, Code section 7522, enacted subsequent to the decision in *Greenberg's Express*, requires specificity in IRS notices, including notices of deficiency. In part, it provides: "Any notice to which this section applies shall describe the basis for, and identify the amounts (if any) of,

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97. See TAX CT. R. PRAC. & P. 23(a)(3) ("The original signature, either of the party or the party's counsel, shall be subscribed in writing to the original of every paper filed by or for that party with the Court, except as otherwise provided by these Rules."); *id.* at 33(b) ("If a pleading is not signed, it shall be stricken, unless it is signed promptly after the omission is called to the attention of the pleader.").

98. *Id.* (emphasis added).

99. Schoenfeld, *supra* note 5, at 529 (footnote omitted).

the tax due, interest, additional amounts, additions to the tax, and assessable penalties included in such notice.”<sup>100</sup>

Enforcement of section 7522 should address Professor Schoenfeld’s concerns about unspecific and uninformative notices. Unfortunately, Tax Court jurisprudence interpreting this provision has not been ideal. Section 7522 also provides that “[a]n inadequate description . . . shall not invalidate [the] notice.”<sup>101</sup> That has the positive effect of avoiding a taxpayer win based on a jurisdictional ruling when the nature of the error actually affects the pleading function of the notice. However, the quoted sentence has the unfortunate effect of precluding one remedy without specifying another.

Over time, the Tax Court has developed the remedy of shifting the burden of proof to the IRS as a remedy for violation of section 7522.<sup>102</sup> This remedy in effect requires the IRS to come up with the explanation it did not afford in the notice of deficiency. It relieves the taxpayer from having to counter an unknown allegation. It is an excellent remedy for a vague notice. Unfortunately, in *Shea v. Commissioner*,<sup>103</sup> the Tax Court applied the same standard as it does to determine if the IRS has raised “new matter,” which requires shifting the burden of proof to the IRS.<sup>104</sup> The “new matter” jurisprudence encourages the IRS to draft broadly worded notices of deficiency so that little raised subsequently will be found inconsistent with the determination in the notice of deficiency.<sup>105</sup> That test for new matter is not appropriate for determining whether the notice is adequately specific and descriptive.<sup>106</sup>

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100. I.R.C. § 7522(a) (1994). The section applies to notices of deficiency. *See id.* § 7522(b).

101. *Id.* § 7522(a).

102. *See Shea v. Comm’r*, 112 T.C. 183 (1999).

We, therefore, hold that where a notice of deficiency fails to describe the basis on which the Commissioner relies to support a deficiency determination and that basis requires the presentation of evidence that is different than that which would be necessary to resolve the determinations that were described in the notice of deficiency, the Commissioner will bear the burden of proof regarding the new basis. To hold otherwise would ignore the mandate of section 7522 and Rule 142(a).

*Id.* at 197; *Straight v. Comm’r*, 74 T.C.M. (CCH) 1457 (1997) (IRS conceded that shifting the burden of proof would be appropriate remedy for section 7522 violation); *Ludwig v. Comm’r*, 68 T.C.M. (CCH) 961, 963 (1994) (“What then remains of the responsibility of the IRS when the Commissioner fails to obey the command of section 7522(a)? Perhaps this Court could fashion some sort of remedy for the taxpayer, such as imposing the burden of proof, or at least the burden of going forward, on the Government.”).

103. 112 T.C. 183 (1999).

104. *See id.* at 193-94; TAX CT. R. PRAC. & P. 142(a); *see also Elliott v. Comm’r*, 82 T.C.M. (CCH) 13, \*21 (2001) (“In a recent case, we considered whether the Commissioner’s position was new matter in the context of section 7522.” *Citing Shea v. Comm’r*, 112 T.C. 183 (1999)).

105. *See Leandra Lederman Gassenheimer, The Dilemma of Deficient Deficiency Notices*, 73 TAXES 83 (1995) (containing a detailed discussion).

106. *See Leandra Lederman, Deficient Statutory Notices and the Burden of Proof: A Reply to*



For example, in *Sellers v. Commissioner*,<sup>107</sup> the notice of deficiency stated that the IRS had disallowed the taxpayers' bad debt deduction "because it has not been established that any amount of bad debts existed in fact and in law."<sup>108</sup> Similarly, the IRS stated that it disallowed a net operating loss carryover "because it has been determined that a net operating loss did not exist in the year that caused the carryforward."<sup>109</sup> The Tax Court stated, with respect to section 7522, "At trial, [the IRS] has taken no position that would require [the taxpayers] to present evidence different from that necessary to resolve the determinations that were described in the notice of deficiency, so as to justify placing the burden of proof on [the IRS]."<sup>110</sup> In fact, the broader the statement in the notice of deficiency, the less likely different evidence would be needed to prove post-notice positions adopted by the IRS. Fortunately, the Tax Court does recognize the purpose of section 7522.<sup>111</sup> Additional reform in this area would solve the problem; *Greenberg's Express* need not be overruled.

### C. Obtaining the Revenue Agent's Report

Professor Schoenfeld argues that, because of *Greenberg's Express* and assertions of privilege, the IRS "consistently argues that all documents supporting its computations of a deficiency are . . . not discoverable."<sup>112</sup> He focuses on the revenue agent's report.<sup>113</sup> Yet, many, if not most, taxpayers receive the revenue agent's report *before* ever receiving a notice of deficiency; it generally arrives with the thirty-day letter. In fact, in order to demonstrate the function of the revenue agent's report, Professor Schoenfeld quotes *Block-Southland Sportswear Co. v. United States*<sup>114</sup> as saying, "The purpose of such letter and report is to inform the taxpayer of the results of an income tax audit for a particular year and to extend to him an opportunity to request a conference for a further discussion of a proposed adjustment in his tax liability."<sup>115</sup> The prior sentence of that opinion states, "On June 23, 1971, under Section 6532(a)(1) of the Internal Revenue Code of 1954, the District Director of Internal Revenue of the State of North Carolina issued to plaintiff his Form L191 (Rev. 3-69) commonly known as a 'thirty-day letter' to which was attached a Revenue

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Mr. Newton, 92 TAX NOTES 117, 122-23 (2001) (criticizing *Shea's* approach to § 7522).

107. 80 T.C.M. (CCH) 135 (2000).

108. *Id.* at 138.

109. *Id.*

110. *Id.* at 139 (citation omitted).

111. See *Elliott v. Comm'r*, 82 T.C.M. (CCH) 13, \*22 (2001) ("[The *Shea*] holding was predicated on our understanding that the purpose of section 7522 is to give taxpayers notice of the basis for a deficiency determination.").

112. Schoenfeld, *supra* note 5, at 536.

113. See *id.* at 536-37.

114. 73-1 USTC ¶ 9230, *aff'd*, 480 F.2d 921 (4th Cir. 1973).

115. Schoenfeld, *supra* note 5, at 537 n.122 (quoting *Block-Southland Sportswear Co.*, 73-1 USTC ¶ 9230).

*Agent's Report.*<sup>116</sup>

If the taxpayer does not receive a copy of the revenue agent's report with the thirty-day letter, many practitioners request it (and in fact, often request the entire administrative file) as soon as the notice of deficiency arrives.<sup>117</sup> If an informal request is unsuccessful, a Freedom of Information Act request is in order. That may or may not result in obtaining the file in time for use in Tax Court litigation. If it does not, use of the Tax Court's discovery procedures is the remaining option.

Professor Schoenfeld states that,

[i]n effect, the Service is asserting that *everything* its employees do at *any time* is potentially part of some future litigation and, thus, not discoverable. This position reinforces the Service's position in *Greenberg's Express*, sharply decreasing the likelihood that a petitioner will find a basis for any error in a Statutory Notice.<sup>118</sup>

Yet, *Peterson v. United States*,<sup>119</sup> the case that Professor Schoenfeld discusses immediately following the quoted language, contradicts the assertion that the taxpayer will be hampered. In that case, although the government argued that documents were privileged as prepared in anticipation of litigation or for trial, the court did not so find:

The only indication before the court that the documents were so prepared are conclusory statements by counsel for the Government. The Government has neither shown nor offered to show that such documents are trial preparation material. *Generally, it is this court's belief that IRS appellate conferee reports and IRS field agent reports are not prepared in anticipation of litigation or for trial.* Presumably they are prepared in the assessment and review process and, if they be held to be in anticipation of litigation, it is hard to see what would not be. Litigation cannot be anticipated in every such case when relatively few result in litigation. Since no showing to the contrary has been made or offered, it is this court's finding that the contents of the documents sought to be discovered by the plaintiffs through Interrogatories Nos. 6 and 8 are not trial preparation material and are not protected from discovery by rule 26(b)(3).<sup>120</sup>

*Peterson* was not the only case in which the taxpayer was able to obtain

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116. *Block-Southland Sportswear Co.*, 73-1 USTC ¶ 9230.

117. *Cf. Swanson v. Comm'r*, 106 T.C. 76, 81 (1996) ("Because the notice of deficiency failed to adequately explain respondent's bases for determining deficiencies and additions to tax with respect to the years at issue, petitioners requested and received the revenue agent's report in their case.").

118. Schoenfeld, *supra* note 5, at 537 (emphasis in original).

119. 52 F.R.D. 317 (S.D. Ill. 1971).

120. *Id.* at 320-21 (emphasis added).



revenue agent reports. In *Hernley v. United States*,<sup>121</sup> a case in which the taxpayer sought disclosure of grand jury materials, the Court of Appeals for the Seventh Circuit stated: “In support of their claim of right to depose Agent Johnson, the *Hernly* defendants asserted that in discovery they had obtained a copy of Agent Johnson’s Revenue Agent’s Report.”<sup>122</sup> The court also described contents of that report, including contents relating to civil fraud.<sup>123</sup>

Professor Schoenfeld’s concern may be that *Peterson* and other favorable cases were not decided by the Tax Court. He states:

[T]he [Internal Revenue] Service . . . often refuses to disclose exactly how it calculated the dollar amounts of the taxpayer’s asserted tax deficiencies, based upon its overly broad interpretation of case law. This refusal to disclose details seems to be contrary to the discovery rules of the Tax Court; however, the court usually agrees with the Service’s position because it does not wish to look into the inner administrative workings of the agency.<sup>124</sup>

Tax Court discovery rules seem to allow taxpayers to obtain revenue agents’ reports. Tax Court Rule 70(b)(1) states in part, “The information or response sought through discovery may concern any matter not privileged and which is relevant to the subject matter involved in the pending case.”<sup>125</sup> In *Haag v. Commissioner*,<sup>126</sup> the Tax Court admitted a thirty-day letter and revenue agent’s report into evidence “for the limited purpose of showing the basis for the deficiency determination, and not as proof of the facts contained therein.”<sup>127</sup> The Tax Court does not always admit revenue agents’ reports into evidence, but inadmissibility of evidence does not preclude its availability through discovery. “It is not ground for objection [to discovery] that the information or response sought will be inadmissible at the trial, if that information or response appears reasonably calculated to lead to discovery of admissible evidence, regardless of the burden of proof involved.”<sup>128</sup>

In *Rountree Cotton Co. v. Commissioner*,<sup>129</sup> a case submitted to the court fully stipulated, the Tax Court refused to admit into evidence a revenue agent’s report that the taxpayer had received “before issuance of the notice of deficiency.”<sup>130</sup> The court sustained the IRS’s relevance objection, finding that the IRS’s pre-notice administrative record was irrelevant given the absence of

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121. 832 F.2d 980 (7th Cir. 1987).

122. *Id.* at 982 (emphasis added).

123. *See id.* at 982-83.

124. Schoenfeld, *supra* note 5, at 518.

125. TAX CT. R. PRAC. & P. 70(b)(1).

126. 88 T.C. 604 (1987), *aff’d*, 855 F.2d 855 (8th Cir. 1988).

127. *Id.* at 622 n.14.

128. TAX CT. R. PRAC. & P. 70(b)(1).

129. 113 T.C. 422 (1999), *aff’d*, 2001 U.S. App. Lexis 5258 (10th Cir. 2001).

130. *Id.* at 426.

allegations of unconstitutional IRS conduct.<sup>131</sup> However, Professor Schoenfeld's objection seems to be that the revenue agent's report may be *unavailable* to the taxpayer, not that it will be *inadmissible* as evidence supporting the taxpayer. In *Rountree Cotton*, as in most other cases, the taxpayer will already have obtained the report.<sup>132</sup>

## II. PROOF IN TAX FRAUD CASES

Although Professor Schoenfeld's primary concern seems to be with obtaining information from the IRS, he also expresses concern about the IRS's methods for proving tax fraud, particularly the use of collateral estoppel, badges of fraud, and allocation of the proceeds of a criminal conspiracy. Each of these is discussed below.

Code section 6663(a) contains the fraud penalty. It provides: "If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud."<sup>133</sup> Therefore, a civil fraud case requires proof of both underpayment of tax and fraud. The IRS has the burden of proving fraud, and it must do so by clear and convincing evidence.<sup>134</sup> In fact, the IRS must establish *each element* of fraud with that level of proof. Collateral estoppel and so-called "badges of fraud" are techniques the IRS uses to meet its burden of proving the fraud element. The underpayment element generally requires additional evidence.

An underpayment of tax in a fraud case generally stems either from disallowed deductions or unreported income. Professor Schoenfeld's article focuses on cases involving unreported income, particularly cases involving illegal income. Because of the difficulties of proving the negative of nonreceipt, an IRS determination of receipt of profits from an illegal enterprise requires some predicate evidence connecting the taxpayer to the activity.<sup>135</sup> The importance of this element of the proof is discussed below.

### A. Methods of Proving Fraud

1. *Collateral Estoppel*.—Professor Schoenfeld states that "[c]ollateral estoppel is . . . a no-win situation for the taxpayer: heads the Service wins, tails the taxpayer loses."<sup>136</sup> He is referring to the reality that in addition to the fact that a *conviction* of criminal tax evasion<sup>137</sup> estops the taxpayer from denying the

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131. *Id.*

132. See *supra* notes 113-28 and accompanying text.

133. I.R.C. § 6663(a) (1994).

134. See *id.* § 7454(a); TAX CT. R. PRAC. & P. 142(b).

135. *Anastasato v. Comm'r*, 794 F.2d 884, 887 (3d Cir. 1986); *Gerardo v. Comm'r*, 552 F.2d 554, 556 (3d Cir. 1977).

136. Schoenfeld, *supra* note 5, at 549 n.189.

137. For purposes of applying collateral estoppel, a plea of guilty is treated the same as a conviction. See, e.g., *McCulley v. Comm'r*, 73 T.C.M. (CCH) 3163, 3165 n.5 (1997); see also



elements of the crime, *acquittal* of a tax crime does not preclude a subsequent civil trial because the burden of proof is lower in a civil fraud trial (“clear and convincing evidence,” as opposed to “beyond a reasonable doubt”). This is not unique to tax cases; it is well known that when O.J. Simpson was acquitted of the murders of Nicole Brown and Ronald Goldman,<sup>138</sup> collateral estoppel did not preclude successful wrongful death suits by the families of the victims.<sup>139</sup> In fact, it is logical that although conviction under a higher standard of proof precludes contesting the predicate findings under a lower standard of proof, acquittal under a higher standard of proof does not preclude a subsequent suit under a lower standard of proof.

The doctrine of collateral estoppel allows a court to preclude relitigation of an issue that was decided in a previous case that involved the party against whom estoppel is sought. “Collateral estoppel, like the related doctrine of *res judicata*, has the dual purpose of protecting litigants from the burden of relitigating an identical issue with the same party or his privy and of promoting judicial economy by preventing needless litigation.”<sup>140</sup> The issue with respect to which estoppel is sought must have been necessary in reaching the original decision,<sup>141</sup> as well as part of a “valid and final judgment.”<sup>142</sup> In addition, courts consider whether the party sought to be estopped had a “full and fair opportunity to litigate”<sup>143</sup> the issue in the first suit.<sup>144</sup>

As previously indicated, burden of proof is also considered when a party seeks estoppel. Acquittal of a criminal charge is “an adjudication that the proof was *not sufficient to overcome all reasonable doubt* of the guilt of the accused.”<sup>145</sup> Accordingly, acquittal does not preclude a subsequent civil trial on the same issues;<sup>146</sup> the standard of proof is lower in a civil proceeding.<sup>147</sup> In

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Johnson v. Sawyer, 47 F.3d 716, 722 n.13 (5th Cir. 1995). However, there are good arguments that a plea should be analyzed differently. See Kathleen H. Musslewhite, *The Application of Collateral Estoppel in the Tax Fraud Context: Does It Meet the Requirement of Fairness and Equity?*, 33 AM. U. L. REV. 643 (1984).

138. See Julian A. Cook, Jr. & Mark S. Kende, *Color-blindness in the Rehnquist Court: Comparing the Court's Treatment of Discrimination Claims by a Black Death Row Inmate and White Voting Rights Plaintiffs*, 13 T.M. COOLEY L. REV. 815, 852 n. 193 (1996) (referring to *State of California v. Orental James Simpson*, B.A. 097211 (Cal. Super. Ct., Oct. 1, 1995)).

139. See Complaint for Damages for Wrongful Death Goldman v. Simpson, No. SC03640 (Cal. Super. Ct., L.A. County May 4, 1995), <http://www.court tv.com/casefiles/simpson/documents/goldcomp.html>; Complaint for Damages—Survival Action Brown v. Simpson, No. SC036876 (Cal. Super. Ct., L.A. County June 12, 1995), <http://www.court tv.com/casefiles/simpson/documents/browncomp.html>.

140. *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 326 (1979) (footnote omitted).

141. *Id.* at 326 n.5.

142. *Ashe v. Swenson*, 397 U.S. 436, 443 (1970).

143. *Montana v. United States*, 440 U.S. 147, 154 (1979).

144. See, e.g., *id.*

145. *Lewis v. Frick*, 233 U.S. 291, 302 (1914) (emphasis added).

146. E.g., *Helvering v. Mitchell*, 303 U.S. 391, 397 (1938) (“That acquittal on a criminal

addition, criminal conviction precludes relitigation in a civil case of the elements of the offense:

Because of the higher standard of proof and the numerous safeguards surrounding a criminal trial, a conviction in a criminal action is conclusive in a subsequent civil litigation between the same parties as to issues that were actually litigated and adjudicated in the prior criminal proceeding.<sup>148</sup>

The rationale behind applying collateral estoppel makes as much sense in tax cases as it does in other cases. Tax *fraud* cases are no exception. Thus, as Professor Schoenfeld notes, a taxpayer convicted of criminal tax fraud under Code section 7201 will likely be estopped from denying tax fraud in a subsequent civil suit.<sup>149</sup>

Under section 7201, the government must prove, beyond a reasonable doubt, that the taxpayer "willfully attempt[ed] in any manner to evade or defeat any tax . . . ." <sup>150</sup> In *Amos v. Commissioner*,<sup>151</sup> the Tax Court held that the *willfulness* element of section 7201 encompasses all of the elements of the fraud provision that is now Code section 6663.<sup>152</sup> Given the identity of issue combined with the

charge is not a bar to a civil action by the Government, remedial in its nature, arising out of the same facts on which the criminal proceeding was based has long been settled.").

147. See Commander Roger D. Scott, *Kimmel, Short, Mcvay: Case Studies in Executive Authority, Law and the Individual Rights of Military Commanders*, 156 MIL. L. REV. 52, 109 n.212 (1998) ("The same evidence that might not meet the higher standard of proof applicable in a criminal context ('beyond a reasonable doubt') might satisfy the standard of proof for liability in a civil context ('a preponderance of evidence')."). Civil fraud proceedings have an intermediate standard of proof, "clear and convincing evidence." *E.g.*, *Considine v. United States*, 683 F.2d 1285, 1286 n.1 (9th Cir. 1982); *Powell v. Granquist*, 252 F.2d 56, 61 (9th Cir. 1958).

148. Sec. & Exch. Comm'n v. Everest Mgmt. Corp., 466 F. Supp. 167, 172 (S.D.N.Y. 1979) (footnote omitted); see also *Emich Motors Corp. v. Gen. Motors Corp.*, 340 U.S. 558, 568 (1951) (stating that "[i]t is well established that a prior criminal conviction may work an estoppel in favor of the Government in a subsequent civil proceeding.").

149. See Schoenfeld, *supra* note 5, at 547.

150. I.R.C. § 7201 (1994). The section provides, in full:

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.

*Id.*

151. 43 T.C. 50 (1964), *aff'd*, 360 F.2d 358 (4th Cir. 1965), *overruled in part on other grounds* by *Meier v. Comm'r*, 91 T.C. 273 (1988).

152. *Id.* at 55; see also I.R.C. § 6663(a) (1994) ("If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud."). *Amos* was applying the fraud provision that used to be contained in Code section 6653(b). See *Amos*, 43 T.C. at 52.



higher burden of proof required in the criminal case, estoppel can apply to preclude the taxpayer to deny tax fraud if he was convicted of a willful attempt to evade or defeat tax.<sup>153</sup>

In addition, there is an array of tax crimes that do *not* estop the taxpayer from denying civil tax fraud.<sup>154</sup> Many of these other crimes are more easily proven by the IRS because they do not require proof of a tax deficiency, and Code section 7201 does.<sup>155</sup> Thus, not every taxpayer convicted of a tax crime will face collateral estoppel in a subsequent civil case.

2. *Badges of Fraud*.—Commission of fraud requires scienter. That is, negligent or even grossly negligent activity does not constitute fraud because fraud has an intent element. It is rarely possible for the IRS to prove to a court the taxpayer's intent to violate the law through direct evidence (such as a confession). Accordingly, the IRS uses circumstantial evidence known as "badges of fraud" to try to meet its burden. Professor Schoenfeld lists ten of the badges fraud frequently used in civil tax cases:

- A. A Pattern of Understatement.
- B. Concealment of Assets or Sources of Income.
- C. Dealings in Cash.
- D. Failure to Maintain Books and Records.
- E. Engaging in Illegal Activities.
- F. Attempting to Conceal Illegal Activities.
- G. Failure to Cooperate with Tax Authorities.
- H. Showing a Willingness to Defraud Business Associates or Others.
- I. Taxpayer's Sophistication, Education, and Knowledge of Duty to Report Income.
- J. Giving Implausible Explanations.<sup>156</sup>

Most of the items on the above list—other than item I., which is not focused on acts—comport with intuition about the likely behavior of an individual engaged in tax fraud. With respect to the first item on his list, a pattern of understatement, Professor Schoenfeld states:

In any year for which the taxpayer has been convicted of filing a false return, under I.R.C. § 7206(1) (1999) [sic], the Service will treat that year as part of a pattern of understatement, thereby helping prove the intent to evade. However, this reasoning is circular and illogical. In *Wright*, the Tax Court decided that a conviction for filing a false return

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153. See, e.g., *Blohm v. Comm'r*, 994 F.2d 1542, 1554 (11th Cir. 1993); *Klein v. Comm'r*, 880 F.2d 260, 262 (10th Cir. 1989); *Gray v. Comm'r*, 708 F.2d 243 (6th Cir. 1983), *cert. denied*, 466 U.S. 927 (1984); *Fontneau v. United States*, 654 F.2d 8, 10 (1st Cir. 1981) (per curiam); *Amos v. Comm'r*, 43 T.C. 50, 56 (1964), *aff'd*, 360 F.2d 358 (4th Cir. 1965).

154. See, e.g., I.R.C. §§ 7203, 7206, 7207 (1994 & Supp. V 1999).

155. See *Sansone v. United States*, 380 U.S. 343, 351 (1965); *Lawn v. United States*, 355 U.S. 339, 361 (1958).

156. Schoenfeld, *supra* note 5, at 556.

under I.R.C. § 7206(1) (1999) does not equal fraud, because the required intent to evade tax is not an element of I.R.C. § 7206(1) (1999). It is quite illogical to say that § 7206(1) requires an additional factor to show fraud, and then attempt to prove that additional factor by invoking § 7206(1) itself.<sup>157</sup>

Certainly conviction of a section 7206(1) offense does not in and of itself establish fraud. If it did, it could be used to estop the taxpayer from rebutting a civil fraud claim for the same year.<sup>158</sup> That is, unlike Code section 7201, section 7206(1)<sup>159</sup> does not contain an element of intent to evade taxes,<sup>160</sup> nor does it require proof of an understatement of tax. The civil fraud penalty requires proof of both.<sup>161</sup> Nonetheless, conviction of a section 7206(1) violation is highly relevant. It demonstrates intent to file a false return, an illegal activity. If the return in fact understated tax, that is an instance of understatement of tax.<sup>162</sup> If there are other such instances, they may form a pattern. A pattern of understatement is an indicium of fraudulent intent.<sup>163</sup>

In *Investment Research Associates v. Commissioner*,<sup>164</sup> a fairly recent tax fraud case, the Tax Court compiled a longer list of indicia of fraud that included the following:

- 1) failure to produce records during discovery;
- 2) destruction of records;
- 3) misleading statements or actions;
- 4) commingling of personal assets with those of the taxpayer's corporation in an attempt to avoid tax;
- 5) diversion of income to third parties;

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157. *Id.* at 557-58 (footnotes omitted).

158. *See supra* notes 153-55 and accompanying text.

159. Code section 7206 provides, in relevant part:

Any person who—

(1) . . . Willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter . . . shall be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.

I.R.C. § 7206 (1994).

160. *See United States v. Bishop*, 412 U.S. 346, 359-60 & n.8 (1973).

161. *See I.R.C. § 6663(a)* (1994).

162. *See, e.g., Considine v. United States*, 645 F.2d 925, 928-31 (Ct. Cl. 1981) (holding that prior conviction under section 7206(1) estopped taxpayer from contesting that the return was willfully false and resulted in an underpayment of tax, as indictment had charged that return was false because items of income were omitted).

163. "The existence of *several* indicia is persuasive circumstantial evidence of fraud." *Inv. Research Assocs. v. Comm'r*, 78 T.C.M. (CCH) 951, 1081 (1999) (emphasis added).

164. *Id.*



- 6) reporting income from property beneficially owned by the taxpayer on the returns of family members;
- 7) structuring of a business and use of cash management techniques which made difficult the tracing of income;
- 8) banking devices used to conceal earnings;
- 9) concealing income under the names of other persons who reported such income;
- 10) omission of income from the taxpayer's property, title to which was held in names of others who reported the income therefrom.<sup>165</sup>

Of course, as Professor Schoenfeld states, a taxpayer could have reasons other than tax evasion for engaging in any of these acts.<sup>166</sup> Thus, these items are merely indicia of fraud, not proof of fraud. Professor Schoenfeld expresses concern that "[t]he Service can assert, as an indicia [sic] of fraud, every badge of fraud against a taxpayer that could possibly be true. Of course, the Service will not assert any countervailing factors."<sup>167</sup> He is probably right. However, in an adversary system, assertion of countervailing factors and evidence is the job of the taxpayer and his counsel, not of the IRS. In addition, the question of fraud is a factual one that courts resolve by considering the entire record.<sup>168</sup>

### B. Reconstruction of Income

Professor Schoenfeld understandably expresses great concern with respect to proper allocation of gross income in a tax fraud case involving co-conspirators.<sup>169</sup> There are inherent difficulties in reconstructing unreported income, and those difficulties are compounded if proceeds from an enterprise were divided among the participants. That is, conspiracy fraud cases may raise more risk of an excessive deficiency determination with respect to a particular taxpayer than do fraud cases involving a single individual.<sup>170</sup>

The IRS makes the initial determination of the amount of gross income

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165. *Id.* (citations omitted). *Investment Research Associates* cites the following cases: *United States v. Walton*, 909 F.2d 915 (6th Cir. 1990); *Scallen v. Commissioner*, 877 F.2d 1364, 1370-71 (8th Cir. 1989); *Furnish v. Commissioner*, 262 F.2d 727 (9th Cir. 1958); *Maddas v. Commissioner*, 114 F.2d 548 (3d Cir. 1940); *Lewis v. Commissioner*, 46 T.C.M. (CCH) 1311 (1983), *aff'd*, 762 F.2d 1009 (6th Cir. 1985); *McManus v. Commissioner*, 31 T.C.M. (CCH) 999 (1972), *aff'd*, 486 F.2d 1399 (4th Cir. 1973); *Estate of Beck v. Commissioner*, 56 T.C. 297 (1971); *Lang v. Commissioner*, 20 T.C.M. (CCH) 666 (1961); *Hecht v. Commissioner*, 16 T.C. 981 (1951).

166. Schoenfeld, *supra* note 5, at 567.

167. *Id.*

168. *See, e.g.*, *Gajewski v. Comm'r*, 67 T.C. 181, 199 (1976), *aff'd*, 578 F.2d 1383 (8th Cir. 1978).

169. *See* Schoenfeld, *supra* note 5, at 541.

170. *See, e.g.*, *Jones v. Comm'r*, 903 F.2d 1301, 1302-03 (10th Cir. 1990) (upholding deficiency based on \$33 million of unreported income from drug sales in a particular location, where taxpayer denied involvement but did not explain who might be receiving the drug proceeds instead).

allocable to a taxpayer. Its determination is reflected in the notice of deficiency. As discussed previously, even in civil cases not involving fraud, a determination of unreported income must have some support if the taxpayer denies receipt of income.<sup>171</sup> A determination without foundation is "arbitrary and erroneous."<sup>172</sup> If the taxpayer alleges such a "naked assessment," the burden of going forward shifts to the IRS. If the IRS cannot support its determination, generally by linking the taxpayer to an illegal tax-generating activity, the IRS loses.<sup>173</sup>

In civil cases involving an allegation of unreported income, if the taxpayer denies receiving the income, the IRS may use a variety of techniques to "reconstruct" that income. Court-approved techniques include the net-worth method, which "is particularly well-suited to ferreting out hidden income, especially income from illegal sources;"<sup>174</sup> the cash transaction method; the bank deposits method; the specific items method; the source and application of funds method; and the T-account method.<sup>175</sup> Each one seeks to establish the amount of income earned by the taxpayer and to compare it to the taxpayer's return to determine the amount of unreported income, if any.

In a case involving a fraud penalty, the IRS bears the burden of proving both fraud and an underpayment of tax by clear and convincing evidence. Use of these methods of reconstructing income assists the IRS in proving that there was an underpayment of tax; absent an underpayment, the fraud penalty does not apply.<sup>176</sup> However, once the IRS proves fraud, the burden shifts to the taxpayer to establish the amount of the deficiency *not* attributable to fraud.<sup>177</sup> A denial of the underlying activities will not help the taxpayer at this stage, because the court will not reach this stage unless it is convinced that the taxpayer committed fraud.<sup>178</sup>

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171. See *supra* text accompanying notes 35-42.

172. *Id.*

173. *Id.*

174. Linda S. Eads, *From Capone to Boesky: Tax Evasion, Insider Trading, and Problems of Proof*, 79 CAL. L. REV. 1421, 1426 (1991). In *Holland v. United States*, 348 U.S. 121 (1954), the United States Supreme Court approved the use of the "net worth" method but required proof of a "likely source" of the unreported income. *Id.* at 132, 137-38.

175. See LEDERMAN & MAZZA, *supra* note 26, at 80.

176. See I.R.C. § 6663(a) (1994).

177. See *id.* § 6663(b).

178. *Cf. Jones v. Comm'r*, 903 F.2d 1301, 1303 (10th Cir. 1990) (upholding IRS assertion of \$33 million of unreported income). The court stated:

Jones offered almost no real evidence to prove that the Commissioner's assessment was erroneous except his weak attempts to distance himself from all drug sales. He made no attempt to suggest a more appropriate or more accurate estimate of his drug related income, nor did he suggest who, if not he, was receiving the majority of income arising from drug trafficking at Hanover Place in 1985.

*Id.* at 373. See also *Mandina v. Comm'r*, 43 T.C.M. (CCH) 359 (1982), *aff'd*, 758 F.2d 1399 (11th Cir. 1984 (per curiam), and *aff'd as modified sub nom. Schaffer v. Comm'r*, 779 F.2d 849 (2d Cir. 1985). In *Mandina*, the court stated:



In conspiracy cases, the IRS faces another level of complication in determining the taxpayer's deficiency, and the taxpayer faces a corresponding complication in rebutting that determination. Once the IRS has reconstructed income from the conspiracy, it must allocate the income among the participants. Professor Schoenfeld refers to allocation of aggregate conspiracy profits as the "slice of the pie" approach.<sup>179</sup> The IRS may alternatively use what Professor Schoenfeld terms the "act-by-act approach,"<sup>180</sup> under which the IRS allocates among co-conspirators profits from each of the conspiracy's acts rather than on an aggregate basis.<sup>181</sup> Under either method of allocation, the IRS may protectively redundantly allocate the total amount (of the pie or of profits from each act).<sup>182</sup>

Professor Schoenfeld expresses concern about the IRS's protective allocation of the same dollar amounts to multiple co-conspirators.<sup>183</sup> This is an important issue because of the taxpayer's burden of proving the amount of the deficiency that is not attributable to fraud.<sup>184</sup> It may be difficult for the taxpayer to prove that too much of the conspiracy's income was assigned to him rather than to co-conspirators, particularly in the likely absence of books and records. Yet, as Professor Schoenfeld notes, if the IRS does not take a protective position, it increases its risk of whipsaw.<sup>185</sup>

Professor Schoenfeld also points out that some co-conspirators may not have received notices of deficiency, perhaps because they were not convicted of

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Since we have concluded that respondent has shown with respect to each petitioner an underpayment of tax in the year 1969, a part of which was due to fraud, it is incumbent on petitioners to show that the amounts of the deficiencies as determined by respondent are in error. Because of the position taken by each petitioner, that he had received no unreported income, it is very difficult to determine exactly how much of the money extracted from DMI by the four petitioners was taken by each.

*Id.* (citation omitted).

179. Schoenfeld, *supra* note 5, at 544.

180. *Id.*

181. *Id.*

182. See *id.* at 543-44. The IRS does not always use redundant allocation. See, e.g., *Barber v. Comm'r*, 39 T.C.M. (CCH) 1026, 1029 (1980) (upholding IRS determination that one-seventh of bank robbery proceeds would be allocated to taxpayer, one of seven participants), *aff'd*, 679 F.2d 896 (9th Cir. 1982).

183. See Schoenfeld, *supra* note 5, at 544-47.

184. See I.R.C. § 6663(b) (1994).

185. Schoenfeld, *supra* note 5, at 543.

A whipsaw situation occurs in the tax field when two taxpayers take positions with respect to a particular transaction which are so inconsistent with each other that only one should logically succeed—and yet, because of jurisdictional or procedural reasons, first one and then the other prevails against the government.

*Remarks by Phillip R. Miller at Court of Claims Judicial Conference, October 14, 1971, on Whipsaw Problems in Tax Cases*, 25 TAX LAWYER 193 (1972).

underlying crimes<sup>186</sup> (and thus fraud would be harder to prove). If one taxpayer successfully argues that part of his "share" was actually received by others, the IRS would be faced with either increasing the deficiency of the others (procedurally disadvantageous), or being whipsawed if those others were either not before the court or had already successfully argued that those amounts were not received by them. Thus, he agrees that "the protective position makes sense"<sup>187</sup> under a "slice of the pie" approach.<sup>188</sup> He nonetheless questions the "logic behind the protective position . . . in act-by-act cases[,] [b]ecause there is no 'pie.'"<sup>189</sup>

Actually, the difference between slice-of-the-pie and act-by-act case is the number of pies and size of those pies. That is, a particular case analyzed as a slice-of-the-pie case would have one large pie for allocation, while that case analyzed on an act-by-act basis would have multiple, smaller pies to allocate. *Mandina v. Commissioner*,<sup>190</sup> quoted below, illustrates this principle.<sup>191</sup>

Redundant allocation of slices of the pie or pies involved protects the IRS, but at the expense of taxpayer difficulties of proof. As Professor Schoenfeld points out, the taxpayer may not know until after trial how much the IRS really plans to attribute to him, hampering his defense.<sup>192</sup> Yet all is not lost. "The Commissioner has the right to make inconsistent determinations to protect the public fisc, *as long as none of the deficiencies has been collected and the Commissioner acknowledges only one tax liability is due.*"<sup>193</sup> That is, the IRS may collect only one tax on any given deficiency.<sup>194</sup> In fact, the IRS generally will drop its protective position before entry of decision. For example,<sup>195</sup> in *Ryan v. Commissioner*, an act-by-act case<sup>196</sup> that is an important focus of Professor

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186. Schoenfeld, *supra* note 5, at 543.

187. *Id.* at 544.

188. *Id.*

189. *Id.* at 545.

190. 43 T.C.M. (CCH) 359 (1982), *aff'd*, 758 F.2d 1399 (11th Cir. 1984) (per curiam), and *aff'd as modified sub nom.* Schaffer v. Comm'r, 779 F.2d 849 (2d Cir. 1985).

191. *See infra* text accompanying note 200.

192. *See* Schoenfeld, *supra* note 5, at 546-47.

193. *Ryan v. Comm'r*, 75 T.C.M. (CCH) 1778, 1787 (1998) (emphasis added).

194. *See, e.g., Schaffer*, 779 F.2d at 852; *Gerardo v. Comm'r*, 552 F.2d 549, 556 (3d Cir. 1977).

195. Another example used by Professor Schoenfeld is *Arouth v. Commissioner*, 64 T.C.M. (CCH) 1390 (1992). *See* Schoenfeld, *supra* note 5, at 543 n.162. In that case, "[t]he court permitted the protective position until further information was uncovered; when no records or reliable testimony were uncovered regarding the conspirators' division of income, the court determined that it was 'appropriate to approximate the respective percentages of the sales proceeds that each petitioner received.'" *Id.* (quoting *Arouth*, 64 T.C.M. at 1395). In other cases, the IRS abandoned its protective position on brief, arguing instead for pro rata allocations. *See, e.g., Puppe v. Comm'r*, 55 T.C.M. (CCH) 1297, 1300 (1998).

196. Schoenfeld, *supra* note 5, at 544 n.167.



Schoenfeld's article,<sup>197</sup> the court noted, "At trial, [IRS's] counsel stated [IRS's] intention to ask the Court to decide the amounts of income each petitioner received individually. Accordingly, on brief [the IRS] no longer attributes the same dollar of income to more than one [taxpayer]. . . ."<sup>198</sup>

In addition, from the perspective of a particular co-conspirator, consolidating the cases of all parties to the conspiracy may be best because the Tax Court generally will avoid redundant deficiency determinations.<sup>199</sup> For example, in one case, the Tax Court stated:

Because of the lack of evidence and *our belief that it would be totally unfair to tax the same amount to each of these petitioners merely because of their failure to prove the division of the amount*, we conclude that one-third of the \$300,000 obtained from the June 20, 1969, check is taxable to each of petitioners Mandina, O'Nan and Schaffer, and none of this amount is taxable to petitioner Mitchell. Because of this same lack of evidence, we conclude that one-fourth of [the amounts from each of five transactions] is taxable to each of the four petitioners.<sup>200</sup>

Given this approach, consolidating the cases of all parties to the conspiracy may be better for taxpayers in multi-party fraud cases.<sup>201</sup>

Finally, on an act-by-act approach to the conspiracy, if the IRS does not connect a particular taxpayer with a tax-generating act, the court probably will not assign *any* income to the taxpayer from that act. In *Ryan*, the court stated:

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197. See, e.g., *id.* at 517 n.\* ("The opinions of the author are largely based and are augmented by . . . *Ryan*"); *id.* at 535-36 (describing facts surrounding testimony of revenue agent in *Ryan*); *id.* at 545-46 (describing complication in *Ryan* that arose from IRS use of protective positions); *id.* at 553-54 (using *Ryan* as an example of a case in which an element missing after application of partial collateral estoppel may be proven by other means).

198. *Ryan*, 75 T.C.M. at 1787.

199. See, e.g., *Ash v. Comm'r*, 33 T.C.M. (CCH) 974, 976-77 (1974) ("Respondent admits an inconsistent position and acts as a stakeholder. It would, therefore, seem inappropriate to tax both Ash and Cannon on the entire \$64,680. Accordingly we hold that Ash and Cannon each earned one-half of the total sent from Hodges to Ash, or \$32,340."), *aff'd sub nom. Cannon v. Comm'r*, 533 F.2d 959 (5th Cir. 1976).

200. *Mandina v. Comm'r*, 43 T.C.M. (CCH) 359, 373 (1982), *aff'd*, 758 F.2d 1399 (11th Cir. 1984) (*per curiam*), and *aff'd as modified sub nom. Schaffer v. Comm'r*, 779 F.2d 849 (2d Cir. 1985) (emphasis added).

On appeal, the Court of Appeals for the Second Circuit held that Schaffer should not have been attributed any income from certain transactions. *Schaffer*, 779 F.2d at 860. The Court of Appeals for the Eleventh Circuit affirmed the Tax Court's holding with respect to Mandina. Thus, in this case, appeals to different circuits resulted in a partial whipsaw for the IRS.

201. In a sense, once the aggregate deficiency is determined in a multi-party case, the case reflects a sort of reverse interpleader situation, with the IRS as a stakeholder. That is, interpleader serves to determine how to allocate a sum of money among multiple claimants, while in a multi-party tax fraud case, the issue is how to allocate the obligation to pay a sum of money. *Cf. Ash*, 33 T.C.M. (CCH) at 976 ("Respondent admits an inconsistent position and acts as a stakeholder.").

As we review each of respondent's assertions concerning each respective search, we consider whether respondent has presented predicate evidence linking the specific petitioner to the tax-generating activity from which respondent asserts income has arisen for such petitioner. Where there is no such predicate evidence, we attribute no income to that petitioner.<sup>202</sup>

### CONCLUSION

Those accused of civil tax fraud, particularly following a related criminal conviction, will likely face a tough fight with the IRS. Is that fair? It is important to note that the IRS will encounter major obstacles, as well. The taxpayer generally benefits from his superior information about his activities. In addition, in attempting to reconstruct a taxpayer's transactions, the IRS will inevitably face difficulties resulting from the likelihood that a guilty taxpayer will have taken steps to conceal his activities.

Contrary to the impression given by Professor Schoenfeld's article, the taxpayer will not be precluded from receiving information about the IRS's case. Nonetheless, a taxpayer who denies any and all participation in the underlying activity is unlikely to win a tax fraud case if there is proof of his involvement in that activity. The taxpayer will not be able to rebut the amount of conspiracy profits allocated to him if he simply denies any participation in the conspiracy. A complete denial therefore may not be the best strategy, particularly in a case involving a related criminal conviction or substantial evidence of the taxpayer's participation in the conspiracy. Instead, the taxpayer may be able to present evidence indicating that someone else actually received amounts attributed to him.

A taxpayer facing the IRS in a civil fraud case also benefits from certain procedural protections. First, it is the IRS that bears the burden of proving both an underpayment of tax and the element of fraud. Second, its proof must rise to the level of clear and convincing evidence. A criminal conviction of the taxpayer will help the IRS meet that burden. That may seem unfair, but a criminal conviction means that the taxpayer, most likely represented by counsel, was found guilty of a crime beyond a reasonable doubt. Our justice system generally allows both a civil suit following a criminal conviction and use of collateral estoppel in the subsequent civil suit, if its elements are met.

In sum, Professor Schoenfeld's article is a valuable contribution to the limited literature on federal tax controversies. His article reflects serious concerns about the checks on the power of the IRS. This reply has indicated areas in which existing checks are sufficient, as well as areas in which improvements would make the tax controversy process more balanced and procedurally fair.

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202. *Ryan*, 75 T.C.M. (CCH) at 1787-88.



# CREDIT CRISIS TO EDUCATION EMERGENCY: THE CONSTITUTIONALITY OF MODEL STUDENT VOUCHER PROGRAMS UNDER THE INDIANA CONSTITUTION

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## INTRODUCTION

Recently, educational reform and student vouchers have produced many headlines.<sup>1</sup> This Article considers whether model student voucher programs that provide state funds to parents for use at a public or private school of their choice will survive scrutiny under both the Indiana Constitution and the United States Constitution. Ultimately, this Article concludes that such a program offends neither constitution for several reasons. First, a model voucher program does not offend article I, sections 4 and 6 of the Indiana Constitution because the voucher funds do not amount to a subsidy or “donation to the church.”<sup>2</sup> Second, a model voucher program does not offend the Indiana Constitution because the program is consistent with the historical purposes behind the changes made in Indiana’s 1851 Constitution. Finally, this Article concludes that, where state funds flow to religious institutions from neutral, generally applicable programs, the First Amendment’s Establishment Clause is not violated if the funds are directed by the independent, private decisions of third parties. Therefore, a model voucher program is unobjectionable from a constitutional standpoint.

In offering these observations and suggestions on the constitutionality of school voucher programs in Indiana, this Article does not express an opinion on the wisdom of voucher programs or other plans that use state funds to send students to private schools. In fact, one could argue that, because part of the mission of public schools is a perceived<sup>3</sup> overall democratizing effect, voucher

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1. See, e.g., Kim Cobb, *School Vouchers Continue in Ohio Amid Uncertainty: High Court Response Could Spell Life or Death for Cleveland’s Plan*, HOUSTON CHRON., Mar. 25, 2001, available at 2001 WL 3008283; Marjorie Coeyman, *Two Takes on Whether School Vouchers are Constitutional*, CHRISTIAN SCI. MONITOR, Apr. 10, 2001, available at 2001 WL 3734707; Juliet Eilperin & Dana Milbank, *House Panel Votes to Kill Private School Vouchers*, WASH. POST, May 3, 2001, at A1; Robert A. Jordan, *Bush Gets the Message: School Vouchers are a ‘Poison Pill,’* BOSTON GLOBE, Apr. 22, 2001, available at 2001 WL 3930117; Neil Weinberg, *Grass Roots: Heavy-handed Voucher Campaigns Tend to Bomb at the Ballot Box; There’s a Better Way*, FORBES, Mar. 5, 2001 at 116.

2. State *ex rel.* Johnson v. Boyd, 28 N.E.2d 256 (Ind. 1940).

3. To a great extent, the democratizing effect is largely illusory. America’s schools are still

programs that remove students from the public schools and place them in private schools could well be considered an imprudent venture. Additionally, this Article does not suggest that voucher programs are either the only solution or the best solution to the many problems facing national and state education programs.<sup>4</sup> Whether voucher programs are the solution to America's perceived educational crisis does not determine whether such a program can survive constitutional scrutiny.

In order to consider thoroughly the question of a model voucher program's constitutionality under both the Indiana and federal Constitutions, this Article is divided into three parts. In Part I, this Article provides background considerations and a framework for examining programs that provide state funds to parents who use them at the school of their choice, including religious schools. In Part II, this Article examines federal jurisprudence on state funding of religious schools. This section concludes that model voucher programs, through

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highly segregated along racial, ethnic, economic, and social lines. See GARY ORFIELD & SUSAN E. EATON, *DISMANTLING DESEGREGATION: THE QUIET REVERSAL OF BROWN V. BOARD OF EDUCATION* (1996); JAMES T. PATTERSON & WILLIAM W. FREEHLING, *BROWN V. BOARD OF EDUCATION: A CIVIL RIGHTS MILESTONE AND ITS TROUBLED LEGACY* (2001); Martha Minow, *Choice or Commonality: Welfare and Schooling After the End of Welfare as We Knew It*, 49 DUKE L. J. 493 (1999); Wendy Parker, *The Future of School Desegregation*, 94 NW. L. REV. 1157 (2000).

4. For a discussion suggesting that voucher programs may not solve all problems facing the education system, see SAMUEL C. CARTER, *NO EXCUSES: LESSONS FROM 21 HIGH-PERFORMING, HIGH-POVERTY SCHOOLS* (2000). Carter identifies seven traits high-performing schools have: principals are free to make decisions and implement programs; schools use measurable goals to establish a culture of achievement; experienced teachers bring out the best in a faculty through teacher evaluations and other methods; rigorous and regular testing leads to continuous achievement and principals take responsibility for the results; achievement is linked to and made the key to discipline; principals and teachers work with parents to make the home a center of learning (lack of parental and community involvement is often the first cause of poor performance); and greater effort expended by school personnel, students, and teachers, through longer hours, longer school years, and summer school, creates more capable students. It is difficult to argue that such a comprehensive scheme would not have some effect and, at any rate, the solution to the education crisis is unlikely to be a one-pronged effort such as vouchers. While whole-sale reform, along the lines identified by Carter, addresses many systemic problems, vouchers only allow people to opt-out of public schools (a major victory in some places). But see JAY P. GREEN, *AN EVALUATION OF THE FLORIDA A-PLUS ACCOUNTABILITY AND SCHOOL CHOICE PROGRAM*, PROGRAM ON EDUCATION POLICY AND GOVERNANCE AT HARVARD UNIVERSITY (2001) (finding that schools faced with competition from vouchers improved); WILLIAM G. HOWELL ET AL., *TEST-SCORE EFFECTS OF SCHOOL VOUCHERS IN DAYTON, OHIO, NEW YORK CITY, AND WASHINGTON, D.C.: EVIDENCE FROM RANDOMIZED FIELD TRIALS*, PROGRAM ON EDUCATION POLICY AND GOVERNANCE AT HARVARD UNIVERSITY (2000) (finding statistically significant gains in student test scores); PAUL E. PETERSON, ET AL., *AN EVALUATION OF THE CLEVELAND VOUCHER PROGRAM AFTER TWO YEARS*, PROGRAM ON EDUCATION POLICY AND GOVERNANCE AT HARVARD UNIVERSITY (1998) ("[T]he gains witnessed [at the schools studied] suggest that [the Cleveland Scholarship Program] as a whole probably has helped improve student test scores.").



which state funds flow to religious institutions via neutral, generally applicable programs, do not offend the First Amendment's Establishment Clause if the funds are directed by the independent, private decisions of third parties.

In Part III, this Article examines the same question under the Indiana Constitution. This Part first considers the historical background of Indiana's 1816 and 1851 constitutions, because the Indiana Supreme Court has frequently turned to history to inform its interpretations of the Indiana Constitution. This section concludes that the impetus behind the relevant changes in the 1851 Constitution were principally three-fold. First, the 1851 changes were a reaction to the failure of Indiana's voluntary, private, and local school system. Second, the changes were a reaction to Indiana's fiscal collapse and the desire to establish a general school system in a less-expensive fashion. Finally, the changes reflected a desire to do away with special and local legislation, which was perceived as one of the causes of Indiana's fiscal problems. A model voucher program conflicts with none of these constitutional purposes.

Part III next considers Indiana's jurisprudence on article I, sections 4 and 6. This Part concludes that the limited jurisprudence interpreting these provisions has construed them to prohibit only payments made to religious institutions when such payments amount to a "donation to the church" and are not payment for services rendered. As such, sections 4 and 6 work together, as an establishment clause, to prohibit the payment of state funds to religious institutions, when the payment amounts to a gift or subsidy that promotes the institution's religious mission. For two reasons, a model voucher program does not offend sections 4 and 6 under this test. First, the payments have a limited range of uses and may only be used by parents to obtain educational services. Second, private choice forms a barrier between the state and any funds that support an institution's religious mission. Under a model voucher program, any funds that flow to religious schools do so only because individual parents and schools chose to participate in the program. Therefore, the funds are not a state subsidy to promote religion.

## I. BACKGROUND AND FRAMEWORK

By way of background for consideration of model voucher programs under the Indiana and Federal Constitutions, this Part considers three major concepts. First, this section provides a summary of three concerns that the First Amendment's Establishment Clause is often thought to address. Second, this section provides an overview of neutrality, which is an important consideration in many Establishment Clause cases. Finally, this section explains what a "model voucher program" actually is.

The First Amendment's Establishment Clause has been interpreted to have three principal components that set forth the ideal of neutrality between church and state. First, the government should not establish a state religion.<sup>5</sup> Second,

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5. See U.S. CONST. amends. I and XIV.

the government should not promote one existing religion or sect over another.<sup>6</sup> Finally, the state should not favor non-religion over religion, or vice versa.<sup>7</sup> These three components each speak to the problems inherent in state action that is not neutral in its stance towards religion. James Madison explicitly addressed these problems in 1785 in his *Memorial and Remonstrance*:

Who does not see that the same authority which can establish Christianity, in exclusion of all other Religions, may establish, with the same ease any particular sect of Christians, in exclusion of all other Sects? [sic] that the same authority which can force a citizen to contribute three pence only of his property for the support of any one establishment, may force him to conform to any other establishment in all cases whatsoever?<sup>8</sup>

The solution, Madison suggested, was “that equality [in government action] . . . ought to be the basis of every law . . . .”<sup>9</sup> Equality, or neutrality, plainly accords with the three goals of the First Amendment’s Establishment Clause. Nevertheless, neutrality as a test or touchstone continues to be problematic.

Neutrality is an often invoked but little understood concept. The term can be either nebulous or precise, useless or useful.<sup>10</sup> This Article attempts no formal explication of the term, but uses it often, though, for a limited purpose. Neutral government action and neutrality in general, in this Article, mean that similarly situated people are treated equally. Thus, the government does not make distinctions based on impermissible criteria such as race, ethnicity, religion, or gender. A phrase used often in this Article is “neutral, generally applicable program.” With respect to education, a program is generally applicable when it applies to all school children, or all children that meet certain criteria. Such a program is neutral when the criteria used to categorize or separate individuals are not one of the aforementioned invidious criteria, which suggest impermissible government action. In this respect, neutrality is actually a brake on power,

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6. See *Larson v. Valente*, 456 U.S. 228, 255 (1982) (holding that Minnesota’s Charitable Solicitations Act, which provided that only those religious organizations that received more than half of their total contributions from members or affiliated organizations were exempt from the registration and reporting requirements of the Act, was unconstitutional as “precisely the sort of official denominational preference that the Framers of the First Amendment forbade”).

7. See *Everson v. Bd. of Educ.*, 330 U.S. 1, 18 (1947) (“That Amendment requires the state to be a neutral in its relations with groups of religious believers and non-believers; it does not require the state to be their adversary. State power is no more to be used so as to handicap religions than it is to favor them.”). *Accord Church of Lukumi Babalu Aye, Inc. v. City of Hialeah*, 508 U.S. 520, 532 (1993) (“[T]he First Amendment forbids an official purpose to disapprove of a particular religion or of religion in general.”).

8. James Madison, *To the Honorable the General Assembly of the Commonwealth of Virginia: A Memorial and Remonstrance*, in 5 THE FOUNDERS CONSTITUTION 82 (2000).

9. *Id.*

10. See, e.g., *Mitchell v. Helms*, 530 U.S. 793, 878-79 (2000) (Souter, J., dissenting). See also *infra* note 75 and accompanying text.



because it tends to prevent laws that target either groups or individuals.

This Article also makes repeated references to a “model voucher program.” Such a program works like those adopted by Wisconsin<sup>11</sup> and Ohio.<sup>12</sup> The program provides funds (typically \$2000 to \$5500) to the parents of children in public schools. The program is generally applicable and neutral in its selection criteria for eligible families and schools. The funds are made payable to the parents, who must restrictively endorse them to the school of their choice. Hence, the funds do not flow directly to the school. A model voucher program generally contains an opt-out provision<sup>13</sup> for parents who do not want their children to be forced to attend religious activities at the school.<sup>14</sup> In Indiana, the funds for a model voucher program would necessarily come from a source other than the Common School fund, because article VIII, section 3 of the Indiana Constitution requires that all income of the Common School fund “shall be inviolably appropriated to the support of Common Schools, and to no other purpose whatever.”<sup>15</sup> With this framework and background established, this Article turns to state funding of religious schools under the First Amendment.

## II. FEDERAL JURISPRUDENCE: THE ESTABLISHMENT CLAUSE

### *A. Evolution of Establishment Clause Jurisprudence with Respect to Public Aid for Religious Schools*

The key to most cases dealing with state aid to religious schools is, of course, the U.S. Supreme Court’s interpretation of the Establishment Clause. The First Amendment’s Establishment and Free Exercise Clauses provide that “Congress shall make no law respecting an establishment of religion, or prohibiting the free

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11. See *Jackson v. Benson*, 578 N.W.2d 602 (Wis. 1998).

12. See *Simmons-Harris v. Goff*, 711 N.E.2d 203 (Ohio 1999); *Simmons-Harris v. Zelman*, 72 F. Supp. 2d 834 (N.D. Ohio 1999), *aff’d*, *Simmons-Harris v. Zelman*, 234 F.3d 945 (6th Cir. 2000), *petition for cert. granted*, 70 U.S.L.W. 3232 (U.S. Sept. 25, 2001) (No. 00-1751).

13. Wisconsin’s opt-out provision “prohibit[ed] a private school from requiring ‘a student attending the private school under this section to participate in any religious activity if the pupil’s parent or guardian submits to the teacher or the private school’s principal a written request that the pupil be exempt from such activities.’” *Jackson*, 578 N.W.2d at 609 (quoting WIS. STAT. 27 § 4008e (1995)).

14. It is very likely that a religious activities opt-out provision is not necessary for a voucher program to survive constitutional scrutiny. Even without a provision that formally allows parents to have their children opt out of religious activities in school, a voucher program allows parents, children, and schools to opt out at several levels. First, parents can choose not to send their children to a religious school and can instead send them to another private or public school. Second, parents can choose not to participate in the voucher program at all and continue to send their children to public schools. Finally, a religious school can choose to forego participation in the voucher program.

15. IND. CONST. art. VIII, § 3.

exercise thereof . . . .”<sup>16</sup> Whether or not the Supreme Court’s decisions directly govern a particular case, they substantially inform a court’s thinking and will, thus, ultimately control many cases. The most relevant of these decisions are *Lemon v. Kurtzman*,<sup>17</sup> *Committee for Public Education & Religious Liberty v. Nyquist*,<sup>18</sup> *Mueller v. Allen*,<sup>19</sup> *Witters v. Washington Department of Services for the Blind*,<sup>20</sup> *Zobrest v. Catalina Foothills School District*,<sup>21</sup> *Agostini v. Felton*,<sup>22</sup> and *Mitchell v. Helms*.<sup>23</sup> These cases<sup>24</sup> show that the principle of neutrality towards religion has had a fitful, though steadily evolving existence.<sup>25</sup> The principle that the Court has come to embrace is that “government programs that neutrally provide benefits to a broad class of citizens defined without reference to religion are not readily subject to an Establishment Clause challenge just because sectarian institutions may also receive an attenuated financial benefit.”<sup>26</sup> The Supreme Court has also repeatedly emphasized the role of private choice in its considerations of the constitutionality of the payment of state funds to religious institutions, observing that, where government aid “goes to a religious institution . . . ‘only as a result of the genuinely independent and private choices

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16. U.S. CONST. amend. 1. In interpreting these words, the Supreme Court has readily admitted that “candor compels the acknowledgment that we can only dimly perceive the boundaries of permissible government activity in this sensitive area . . . .” *Tilton v. Richardson*, 403 U.S. 672, 678 (1971).

17. 403 U.S. 602 (1971).

18. 413 U.S. 756 (1973).

19. 463 U.S. 388 (1983).

20. 474 U.S. 481 (1986).

21. 509 U.S. 1 (1993).

22. 521 U.S. 203 (1997).

23. 530 U.S. 793 (2000).

24. *Rosenberger v. Rector & Visitors of the University of Virginia*, 515 U.S. 819 (1995), is another important case. In *Rosenberger*, the Court considered whether the University of Virginia could properly deny reimbursement of printing expenses to a Christian student newspaper. The University argued that its interest in preventing a violation of the Establishment Clause justified any infringement on the organization’s free speech rights. The Court first held that the University’s denial of the group’s reimbursement request amounted to viewpoint discrimination, noting that “[h]aving offered to pay the third-party contractors on behalf of private speakers who convey their own messages, the University may not silence the expression of selected viewpoints.” *Id.* at 835. The Court next determined that such discrimination was not justified in order to avoid a violation of the Establishment Clause. The Court held that when benefits flow to a religious organization via a neutral program such as this, “there is no real likelihood that the speech in question is being either endorsed or coerced by the State.” *Id.* at 841-42. *Rosenberger* is important because it suggests that direct payments, where the principal or primary effect is not to advance religion, do not offend the Establishment Clause. *See id.* at 840-843. Benefits that flow to religion for other purposes, the Court observed, are distinguishable from “a general public assessment designed and effected to provide financial support for a church.” *Id.* at 841.

25. All of the cases, except *Witters* and *Rosenberger*, involved parochial schools.

26. *Zobrest v. Catalina Foothills Sch. Dist.*, 509 U.S. 1, 8 (1993).



of individuals' . . . . a government cannot, or cannot easily, grant favors that might lead to a religious establishment."<sup>27</sup> A position that required complete separation would, as the Court suggested in *Everson*, not be neutral and would conflict with another Establishment Clause concern: that the state not promote religion over non-religion or vice-versa.<sup>28</sup> In such an event, churches could not receive police or fire protection or have their trash collected, much less receive the eventual benefits of a model voucher program.<sup>29</sup>

The first case, *Lemon v. Kurtzman*,<sup>30</sup> dealt with challenges to Rhode Island and Pennsylvania laws that provided state funds to supplement teacher salaries. The state assistance was paid directly to teachers and directly to schools, respectively.<sup>31</sup> In this case, the Court set out the widely used *Lemon* test. The Court held that, in order to not offend the First Amendment's Establishment Clause, a law must have a secular legislative purpose; the law's principal or primary effect must be one that neither advances nor inhibits religion; and the law must not foster excessive government entanglement with religion.<sup>32</sup> The laws in question were found infirm because they fostered excessive government entanglement by requiring that the government oversee programs and even audit schools to ensure that funds did not support religious worship.<sup>33</sup> The reasons for the Court's holding are important, because later cases often turn on the fact that the programs in question make direct payments to religious schools. In *Lemon*, the Pennsylvania program, which made direct payments to religious schools, was struck down on entanglement grounds rather than because the principal or primary effect of the direct payments was to advance religion.<sup>34</sup> In fact, the majority's sole paragraph of the opinion devoted to the direct payments made by Pennsylvania suggests that directness was important to the analysis largely because it might foster greater entanglement.<sup>35</sup> *Lemon* thus suggests that, in the absence of entanglement issues, which are generally missing from later cases,<sup>36</sup> direct payments may not be a problem.

In 1973, the Supreme Court decided *Committee for Public Education & Religious Liberty v. Nyquist*,<sup>37</sup> which presents a somewhat analogous factual

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27. *Mitchell*, 530 U.S. at 810 (quoting *Agostini v. Felton*, 521 U.S. 203, 226 (1997)).

28. See *Everson v. Bd. of Educ.*, 330 U.S. 1, 18 (1947).

29. *Id.* at 17-18.

30. 403 U.S. 602 (1971).

31. See *id.* at 607, 609.

32. *Id.* at 612.

33. *Id.* at 619. The Court was also concerned with the "divisive political potential of these programs." *Id.* at 622. However, the Court has subsequently discarded this concern as a determinative factor. See *Agostini v. Felton*, 521 U.S. 203, 233-234 (1997).

34. *Lemon*, 403 U.S. at 621.

35. *Id.*

36. See, e.g., *Agostini*, 521 U.S. at 233-34 (noting the changes in the Court's entanglement jurisprudence).

37. 413 U.S. 756 (1976).

setting to current voucher plans.<sup>38</sup> In *Nyquist*, the law in question was designed to aid private schools and provided for direct state aid for repair and maintenance of private schools, a tuition reimbursement plan for low-income parents, and a tax deduction for persons earning less than \$25,000 whose children attended private schools.<sup>39</sup> The Court took a hardline towards the New York law, holding that its unmistakable effect was to advance religion, and that it was, therefore, void.<sup>40</sup> Inexplicably, as discussed by now Chief Justice Rehnquist in his dissent, the Court concluded that while tax-exempt status for churches was allowable, despite its obvious and direct benefit to churches, the aid given to parents, which was not required to be spent on education, and the available tax deduction, were improper.<sup>41</sup> Similarly, Chief Justice Burger noted in his dissent that the majority also seemed swayed by the fact that the vast majority of program participants were utilizing religious schools (which were overwhelmingly Roman Catholic).<sup>42</sup>

*Mueller v. Allen*,<sup>43</sup> decided by the Court a decade after *Nyquist*, marks a turning point in Establishment Clause jurisprudence. *Mueller*, brought by Minnesota taxpayers, challenged the constitutionality of a state law that allowed parents to deduct actual expenses for their children's tuition, textbooks, and transportation expenses between \$500 and \$700 for grades kindergarten through six and grades seven through twelve, respectively.<sup>44</sup> The Court held that the program had a secular purpose and would not foster excessive state entanglement with religion.<sup>45</sup> The Court introduced several new factors for analysis under the second prong of the *Lemon* test, holding that the program did not have the

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38. *See id.* at 763-66.

39. *Id.*

40. *Id.* at 793. The majority, in holding that the aid, tuition reimbursement, and tax-credit violated the First Amendment, seems to have disregarded the formerly used, more rigorous, "principal or primary effect" test, which referred to the "inevitable and unmistakable effects" of the programs. The majority responds to this complaint in footnote 39 of the opinion and construes earlier cases to require the Court strike down even arrangements where it was a "mere possibility" that state funds would be used to advance religion. *Id.* (citing *Tilton v. Richards*, 403 U.S. 672, 683 (1971)). Moreover, the majority observed that "we need not decide whether the significantly religious character of the statute's beneficiaries might differentiate the present case from a case involving some form of public assistance (e.g., scholarships) made available generally without regard to the sectarian-nonsectarian, or public-nonpublic nature of the institution benefited." *Id.* at 793 n.38. The Court thus reserved the question of whether a voucher-type program violated the Establishment Clause; this fact significantly undercuts the reasoning of the Sixth Circuit Court of Appeals in *Simmons-Harris v. Zelman*. *See infra* Part II.B.

41. *Nyquist*, 413 U.S. at 808-09 (Rehnquist, J., dissenting).

42. *Id.* at 804-05 (Burger, C.J., dissenting). An important side issue to the application of state funds for sectarian schools is the long history of anti-Catholic sentiment that has found expression in court decisions and other official government action. *See id.*; *see also infra* Part III (discussing the Blaine Amendment).

43. 463 U.S. 388 (1983).

44. *Id.* at 390-92.

45. *Id.* at 403.



primary effect of advancing religion because it was one of many deductions, was available to all parents for educational expenses, and provided aid to religious schools only as a result of the decisions of individual parents.<sup>46</sup> The Court observed that the Establishment Clause's historic purposes "simply do not encompass the sort of attenuated financial benefit, ultimately controlled by the private choices of individual parents, that eventually flows to parochial schools from the neutrally available tax benefit at issue in this case."<sup>47</sup> In *Witters v. Washington Department of Services for the Blind*,<sup>48</sup> Justice Powell further described the importance of *Mueller*, stating that:

*Mueller* makes the answer clear: state programs that are wholly neutral in offering educational assistance to a class defined without reference to religion do not violate the second part of the *Lemon v. Kurtzman* test, . . . because any aid to religion results from the private choices of individual beneficiaries.<sup>49</sup>

Such neutral programs satisfy the Establishment Clause's general concerns that the government not establish a state religion, not prefer one existing sect or religion over another, and not promote religion over non-religion (or vice-versa). Excluding religious institutions from such programs would disadvantage them and would amount to preference of non-religion. The *Mueller* holding, therefore, best reconciles the many competing interests.

*Witters* involved an appeal from an order of the Washington Commission for the Blind that denied Witters vocational rehabilitation assistance.<sup>50</sup> The First Amendment was implicated because Witters was studying at a private Christian college and sought to become a pastor. Although the order was upheld on various grounds during the state appeals process, the Supreme Court reversed, finding no constitutional barrier to the provision of funds to an individual who might use such funds to attend a religious college.<sup>51</sup> The fact that the funds were channeled through individuals and were made available under a neutral, generally applicable program was again a key factor to the Court's analysis. The Court noted that "[a]ny aid provided under Washington's program that ultimately flows to religious institutions does so only as a result of the genuinely independent and private choices of aid recipients."<sup>52</sup> It was thus irrelevant whether the aid advanced religion, since the choice to support religious education was made by individuals and not by the state. Therefore, the second prong of the *Lemon* test was satisfied, as was the requirement of a secular purpose. The Court declined to address the factor of entanglement, as it had not been raised in the lower courts.

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46. *Id.* at 396, 397, 399.

47. *Id.* at 400.

48. 474 U.S. 481 (1986).

49. *Id.* at 490-91 (Powell, J., concurring).

50. *See id.* at 483.

51. *Id.* at 486-87.

52. *Id.* at 488.

In 1993, the Supreme Court decided *Zobrest v. Catalina Foothills School District*,<sup>53</sup> which involved a suit by the parents of a deaf child against the school district after it refused to provide a sign-language interpreter, as required under federal and state law,<sup>54</sup> to accompany their child to classes at a parochial school.<sup>55</sup> The Court held that there was no First Amendment bar to providing the interpreter since the aid was provided under neutral programs that provide benefits to a wide range of citizens without reference to religion.<sup>56</sup> Referring to its prior decisions, the Court noted that such programs are not readily subject to First Amendment challenges merely because a religious school may also receive some benefit.<sup>57</sup> *Zobrest* thus begins to clarify or delineate the contours of the Supreme Court's recent First Amendment jurisprudence. As in *Mueller* and *Witters*, the program at issue was a general one that provided neutral benefits without regard to the public, private, religious, or secular nature of the school. Since the program allowed parents to choose their child's school, the interpreter would be present in any particular school solely as a result of the parents' choices, especially because the statute provided no state incentive to choose a religious school.<sup>58</sup> The mere fact that a public employee would be present in a religious school was not a bar because the child was the primary beneficiary of the employee's presence, and an interpreter, unlike a teacher, neither adds to nor subtracts from the school's program. Any religious message simply flows through the interpreter without any state support or interference.<sup>59</sup>

*Agostini v. Felton*,<sup>60</sup> a 1997 case involving state funding for religious schools, is particularly important in that *Agostini* overruled two earlier decisions concerning the controversy.<sup>61</sup> *Agostini* involved an attempt to lift an injunction that prevented New York City from sending public school teachers into parochial schools to provide remedial education to disadvantaged children. The injunction was originally issued after the Court's ruling in *Aguilar v. Felton* that the program involved excessive entanglement of church and state and impermissibly advanced religion.<sup>62</sup> In *Agostini*, the Court overruled *Aguilar* noting that, since the injunction was originally granted, its Establishment Clause jurisprudence had taken a significantly different course.<sup>63</sup> The Court recognized that neither administrative cooperation between church and state nor potential political

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53. 509 U.S. 1 (1993).

54. See Individuals with Disabilities Education Act, 20 U.S.C. § 1400 (1994); ARIZ. REV. STAT. § 15-761 (1991 & Supp. 2000).

55. *Zobrest*, 509 U.S. at 3-4.

56. *Id.* at 10.

57. *Id.* at 8.

58. *Id.* at 10.

59. *Id.* at 13.

60. 521 U.S. 203 (1997).

61. *Agostini* overruled *Aguilar v. Felton*, 473 U.S. 402 (1985), and *School District of Grand Rapids v. Ball*, 473 U.S. 373 (1985). See *Agostini*, 521 U.S. at 235.

62. See *Aguilar*, 473 U.S. at 414.

63. *Agostini*, 521 U.S. at 233-35.



divisiveness were proper considerations under the *Lemon* excessive entanglement test.<sup>64</sup> Further, after *Zobrest*, the third reason for originally granting the injunction, that the program would require pervasive monitoring by public authorities to insure that public employees did not inculcate religion and create excessive entanglement, was no longer valid. In *Zobrest*, after all, the Court refused to assume that public employees would inculcate religion by their mere presence in a religious school.<sup>65</sup>

The most recent, and perhaps most important, legal chapter for voucher programs in the Supreme Court's Establishment Clause jurisprudence is *Mitchell v. Helms*.<sup>66</sup> In *Mitchell*, the Court considered a federal program that "distributes funds to state and local governmental agencies, which in turn lend educational materials and equipment to public and private schools . . . ."<sup>67</sup> The key to *Mitchell* is not necessarily the majority's opinion. Rather, the key lies in Justice O'Connor's concurring opinion, to which the plurality alluded when it held that the program in question

satisfies both the first and second primary criteria of *Agostini*. It therefore does not have the effect of advancing religion. For the same reason, Chapter 2 also "cannot reasonably be viewed as an endorsement of religion. . . ." Accordingly, we hold that Chapter 2 is not a law respecting an establishment of religion.<sup>68</sup>

Justice O'Connor's endorsement inquiry, if not part of the current *Lemon* test, is at least on the minds of a majority of the Court.<sup>69</sup>

Justice O'Connor's concurrence is important as not only a more nuanced opinion than the plurality's, but also as a useful indicator of the Court's future course. Justice O'Connor's opinion begins to delineate the boundaries of the current Court's Establishment Clause jurisprudence. The four votes attached to the plurality opinion, which encouraged a more expansive view of the Clause, probably do not represent where the real power lies. Rather, the fifth vote, either Justice O'Connor or Justice Breyer, will likely decide future cases. Despite the plurality's focus on diversion and neutrality,<sup>70</sup> it seems unlikely that the Court will abandon the *Lemon* test, as revised in *Agostini*.<sup>71</sup> What is more important for the issues surrounding school choice and voucher programs is Justice

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64. *Id.*

65. See *Zobrest v. Catalina Foothills Sch. Dist.*, 509 U.S. 1, 13 (1993).

66. 530 U.S. 793 (2000).

67. *Id.* at 801.

68. *Id.* at 835 (internal citation omitted).

69. See, e.g., *Good News Club v. Milford Cent. Sch.*, 121 S. Ct. 2093 (2001).

70. *Agostini v. Felton*, 521 U.S. 203, 230-35 (1997).

71. In *Lamb's Chapel v. Center Moriches Union Free School District*, Justice Scalia, in his concurrence, likened the disappearance and reappearance of the *Lemon* test to "some ghoul in a late-night horror movie that repeatedly sits up in its grave and shuffles abroad, after being repeatedly killed and buried . . . ." 508 U.S. 384, 398 (1993) (Scalia, J., concurring). One suspects the *Lemon* test will be back.

O'Connor's discussion of divertability and direct funding.<sup>72</sup> Justice O'Connor notes that the issue is not really whether the funding moves directly between the government and the religious entity, but rather whether the funding moves as a result of private choices.<sup>73</sup> This discussion is crucial to complete understanding of the Supreme Court's Establishment Clause jurisprudence as a whole, and Justice O'Connor's views in particular.

Justice O'Connor wrote separately to explain her disagreement with the plurality's focus on neutrality and apparent approval of the actual diversion of public funds for religious use. Justice O'Connor wrote that while neutrality is always a factor to be considered, it is not an element of the inquiry.<sup>74</sup> Writing for the dissent, Justice Souter agreed and usefully noted some of the problems inherent in using neutrality as a test.<sup>75</sup> Not only does neutrality mean different things to different people, but it has also meant different things to the Court at different times. "'Neutrality' has been employed as a term to describe the requisite state of government equipoise between the forbidden encouragement and discouragement of religion; to characterize a benefit or aid as secular; and to indicate [government] evenhandedness in distributing . . . [aid]."<sup>76</sup> Even more enlightening is Justice O'Connor's discussion of divertability. In her concurrence, Justice O'Connor criticized the plurality's apparent willingness to approve actual diversion so long as the program passed muster in other respects.<sup>77</sup>

Justice O'Connor thought divertability was really a secondary factor for Establishment Clause claims. Diversion, it is true, has been approved by the Court.<sup>78</sup> Nonetheless, it has only been approved where aid flowed to a religious institution via a private party, that is, "only as a result of the genuinely independent and private choices of aid recipients."<sup>79</sup> It is private choice that satisfies the Establishment Clause's concerns about diversion, not the neutrality of a program. When aid flows to a religious institution via the private choices of individual actors, it is less like an impermissible direct state subsidy. Private choice is the hallmark of voucher programs and is crucial to their constitutionality. Justice O'Connor's language in this regard is particularly important, as it appears to speak directly to the constitutionality of voucher programs.

[W]hen the government provides aid directly to the student beneficiary,

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72. See *Mitchell*, 530 U.S. at 840-41 (O'Connor, J., concurring).

73. See *id.* (O'Connor, J., concurring).

74. See *id.* at 838-39; see also *Good News*, 121 S. Ct. at 2104 (quoting *Rosenburger v. Rector & Visitors of the Univ. of Va.*, 515 U.S. 819, 839 (1995)) ("[W]e have held that 'a significant factor in upholding governmental programs in the face of Establishment Clause attack is their *neutrality* towards religion.'" (emphasis in original)).

75. See *Mitchell*, 530 U.S. at 878 (Souter, J., dissenting).

76. *Id.* (Souter, J., dissenting).

77. See *id.* at 839 (O'Connor, J., concurring).

78. See *id.* at 840-41 (O'Connor, J., concurring).

79. *Id.* at 841 (O'Connor, J., concurring) (internal quotes omitted).



that student can attend a religious school and yet retain control over whether the secular government aid will be applied toward the religious education. The fact that aid flows to the religious school and is used for the advancement of religion is therefore *wholly* dependent on the student's private decision.<sup>80</sup>

More importantly, the private choices distinction is crucial to Justice O'Connor's endorsement inquiry. Justice O'Connor wrote, "I believe the distinction between a per-capita school-aid program and a true private-choice program is significant for purposes of endorsement."<sup>81</sup> Justice O'Connor's reasoning on this subject is worth quoting in toto.

In terms of public perception, a government program of direct aid to religious schools based on the number of students attending each school differs meaningfully from the government distributing aid directly to individual students who, in turn, decide to use the aid at the same religious schools. In the former example, if the religious school uses the aid to inculcate religion in its students, it is reasonable to say that the government has communicated a message of endorsement. Because the religious indoctrination is supported by government assistance, the reasonable observer would naturally perceive the aid program as *government* support for the advancement of religion. That the amount of aid received by the school is based on the school's enrollment does not separate the government from the endorsement of the religious message. The aid formula does not—and could not—indicate to a reasonable observer that the inculcation of religion is endorsed only by the individuals attending the religious school, who each affirmatively choose to direct the secular government aid to the school and its religious mission. No such choices have been made. In contrast, when government aid supports a school's religious mission only because of independent decisions made by numerous individuals to guide their secular aid to that school, "[n]o reasonable observer is likely to draw from the facts . . . an inference that the State itself is endorsing a religious practice or belief." Rather, endorsement of the religious message is reasonably attributed to the individuals who select the path of the aid.<sup>82</sup>

Justice O'Connor's observations help to elucidate the boundaries of the Court's Establishment Clause jurisprudence, especially in reference to school aid issues.

The Supreme Court has thus moved toward a neutral attitude with respect to the relations between church and state. Justice Powell's concurrence in *Witters* reflects this stance and sums up the Court's stance. "[S]tate programs that are

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80. *Id.* at 842 (O'Connor, J., concurring).

81. *Id.* (O'Connor, J., concurring).

82. *Id.* at 842-43 (O'Connor, J., concurring) (quoting *Witters v. Washington Dep't of Servs. for the Blind*, 474 U.S. 481, 493 (1986) (emphasis in original)).

wholly neutral in offering educational assistance to a class defined without reference to religion do not violate the second part of the *Lemon v. Kurtzman* test, because any aid to religion results from the private choices of individual beneficiaries.”<sup>83</sup> Although the Court has not explicitly considered the question, jurisprudence before *Mitchell* strongly suggests that a model voucher program will pass constitutional muster if the state funds flow to religious institutions via neutral, generally applicable programs and the funds are directed by the independent, private decisions of third parties. *Mitchell* only reinforces this perception.

The plurality’s opinion in *Mitchell* serves to confirm suspicion that Justices Thomas, Scalia, and Kennedy, as well as Chief Justice Rehnquist, would approve a model voucher program. The larger question has always been with respect to Justice O’Connor’s swing vote and whether a model voucher program would survive an endorsement inquiry. Justice O’Connor’s concurring opinion in *Mitchell* answers this question. Her opinion makes it clear that a model voucher program would, in fact, pass the endorsement test. Hence, it seems likely Justice O’Connor, as well as Justice Breyer, who joined the concurring opinion, would approve a model voucher program should it come before the Court. One case that the Supreme Court will soon consider is addressed next.

#### B. *Simmons-Harris v. Zelman and the Future of School Vouchers under the First Amendment*

During its 2001 session, the Supreme Court will hear the case of *Simmons-Harris v. Zelman*<sup>84</sup> the latest chapter in the ongoing litigation surrounding the Ohio School Voucher Program. The Ohio School Voucher Program provided Cleveland students with up to \$2500 for use at private schools within the Cleveland school district and public schools in adjacent districts that chose to participate in the program.<sup>85</sup> The case was first litigated in the Ohio state courts where the Ohio Supreme Court held that the program violated neither the First Amendment nor the Ohio Constitution.<sup>86</sup> The parties then turned to the federal courts and, at the district court level, Judge Solomon Oliver found that the program violated the First Amendment’s Establishment Clause.<sup>87</sup> The case was then appealed to the United States Court of Appeals for the Sixth Circuit, which affirmed Judge Oliver’s holding.<sup>88</sup>

It is safe to say that most watchers of the *Simmons-Harris* case were fairly

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83. *Witters*, 474 U.S. at 490-91 (Powell, J., concurring).

84. 234 F.3d 945 (6th Cir. 2000), *petition for cert. granted*, 69 U.S.L.W. 3763 (U.S. Sept. 25, 2001) (No. 00-1751).

85. See OHIO REV. CODE ANN. § 3313.976 (Anderson 2000).

86. See *Simmons-Harris v. Goff*, 711 N.E.2d 203, 207 (Ohio 1999).

87. See *Simmons-Harris v. Zelman*, 72 F. Supp. 2d 834, 865 (N.D. Ohio 1999), *aff’d*, 234 F.3d 945 (6th Cir. 2000).

88. See *Simmons-Harris v. Zelman*, 234 F.3d 945, 963 (6th Cir. 2000), *petition for cert. granted*, 70 U.S.L.W. 3232 (U.S. Sept. 25, 2001) (No. 00-1751).



surprised with the Sixth Circuit's panel opinion, especially since it followed the Supreme Court's opinion in *Mitchell*. Judge Ryan's vociferous dissent only tended to heighten the surprise. The majority's conclusion, that the Cleveland Voucher Program violates the Establishment Clause, is surprising for three basic reasons.

Initially, the panel's conclusion that the Cleveland Voucher Program violates the Establishment Clause is surprising because of its analysis of *Mitchell v. Helms*, which itself gives rise to three points. First, the panel gave relatively little weight to *Mitchell*, the most recent case on this issue. Primarily, it thought that *Mitchell* merely stood for the fact that *Agostini*'s version of the *Lemon* test was the proper analysis to employ. In fact, the panel seemed desirous of dismissing the case altogether, stating that *Mitchell* was decided by a "sharply divided plurality."<sup>89</sup> Second, notwithstanding its description of *Mitchell*, what is truly curious about the *Simmons-Harris* court's treatment of *Mitchell* is that it found Justice O'Connor's concurring opinion to be the Court's because it took the narrowest grounds.<sup>90</sup> Finally, even after attributing Justice O'Connor's opinion to that of the Court's, the Sixth Circuit proceeded to ignore the most important part of the concurring opinion, in which Justice O'Connor all but approved model voucher programs.<sup>91</sup>

Second, the panel's opinion is curious in that it found *Nyquist* to be the case governing its deliberations.<sup>92</sup> It is of itself strange that the Sixth Circuit would find *Nyquist* still on point given the Supreme Court's own observation in *Agostini*, that "our Establishment Clause law has significant[ly] change[d]"<sup>93</sup> in the last decade. Thus, the panel's conclusion required a fair amount of dissociative reasoning because the Sixth Circuit first found that *Agostini*'s *Lemon* test was the governing standard for school funding cases. It appears the panel thought it should apply *Agostini*'s much-evolved standards, yet simultaneously rely upon *Nyquist*'s rationale and facts. Further, *Nyquist* was factually distinct in one important respect. In *Nyquist*, the admitted purpose of the law was to aid private schools,<sup>94</sup> eighty-five percent of which were religious.<sup>95</sup> Whatever one thinks of the *Nyquist* decision, the facts are simply different in *Simmons-Harris*, where the purpose of the law is to help children escape failing public schools (and public schools in neighboring districts are free to participate).<sup>96</sup> *Nyquist*

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89. *Id.* at 957.

90. *Id.*

91. See *Mitchell v. Helms*, 530 U.S. 793, 842-43 (2000); see also *supra* notes 77-82 and accompanying text.

92. See *Simmons-Harris*, 234 F.3d at 958.

93. *Agostini v. Felton*, 521 U.S. 203, 237 (1997) (internal quotes omitted).

94. *Comm. for Pub. Educ. & Religious Liberty v. Nyquist*, 413 U.S. 756, 763-64 (1973).

95. *Id.* at 768.

96. See *Simmons-Harris*, 234 F.3d at 948. Ohio's General Assembly adopted the program "in response to an order by the United States District Court that placed the Cleveland School District under the direct management and supervision of the State Superintendent of Public Instruction due to mismanagement by the local school board." *Id.*

simply does not govern voucher cases.

Finally, the panel's own reasoning is questionable. The panel essentially concluded that because the participating schools were overwhelmingly religious and the students who participate overwhelmingly choose religious schools, "the Ohio scholarship program is designed in a manner calculated to attract religious institutions and chooses the beneficiaries of aid by non-neutral criteria."<sup>97</sup> Just as Judge Oliver did at the district court level,<sup>98</sup> the Sixth Circuit concluded that because the result tips in favor of religious schools, the legislative program itself must have been designed to foster that outcome.<sup>99</sup> Such is not the case. Though the panel gave lip service to the Supreme Court's vitally important observation that individual choice is a barrier to government endorsement,<sup>100</sup> it concluded that "[t]he idea of parental choice as a determining factor which breaks a government-church nexus is inappropriate in the context of government limitation of the available choices to overwhelmingly sectarian private schools which can afford the tuition restrictions placed upon them and which have registered with the program."<sup>101</sup> Neither of the court's points, that only religious schools can afford to accept vouchers or that only religious schools feel able to register, means that the individual choices do not form a barrier to the government-church nexus.

First, the monetary amount of the vouchers is wholly irrelevant to the question. In no case do vouchers cover the actual cost of tuition. For both religious and private schools, the cost of educating students exceeds the tuition payments made by the state. The choice to participate in such a program (and subsidize participating students from another source) is a wholly private one made by the individual schools. For instance, in Vermont, one parochial school's cost per child was \$5021, while the school charged, at most, \$3000 for tuition.<sup>102</sup> For its part, the Town of Chittenden provided only approximately \$2600 per student.<sup>103</sup> In that case, as in Ohio, it was the school's choice to accept the funding and make up the costs elsewhere. To strike down such programs merely because religious schools have lower costs is to invent a perverse penalty for keeping costs down. It is also wholly disingenuous. The *Simmons-Harris* court, one suspects, would be equally unhappy with the situation were the religious school's costs significantly higher. It is simply the case that religious schools have decided that it is important, despite the costs, to provide educational services to underprivileged Cleveland students while the elite private schools have decided not to serve underprivileged students (either because of the cost or

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97. *Id.* at 961.

98. *See Simmons-Harris v. Zelman*, 72 F. Supp. 2d 834, 863 (N.D. Ohio 1999).

99. *See Simmons-Harris*, 234 F.3d at 960-61.

100. *See, e.g., Witters v. Washington Dep't of Servs. for the Blind*, 474 U.S. 481, 488 (1986); discussion *supra* Part II.A.

101. *Simmons-Harris*, 234 F.3d at 960.

102. *Chittenden Town Sch. Dist. v. Dep't of Educ.*, 738 A.2d 539, 543 (Vt.), *cert. denied*, 528 U.S. 1066 (1999). *Chittenden Town School District* is a tuition case and not a voucher case (as it is commonly misinterpreted to be), but the point holds.

103. *Id.*



for other reasons).

Second, to strike down a program because some schools have chosen to register and some have not is simply wrong-headed. Again, registration represents wholly private choices. There is nothing in the program that prevents schools from registering. It is simply that religious schools have decided to educate Cleveland's underprivileged students and elite private schools and other public schools<sup>104</sup> have chosen not to educate them.

Nevertheless, in one respect the *Simmons-Harris* panel opinion is on target. This is primarily because of language in *Agostini* that some courts have interpreted as urging the appellate courts not to guess on future cases. In *Agostini*, though the Supreme Court acknowledged a great deal of change in its Establishment Clause jurisprudence and therefore overruled earlier decisions in *Ball* and *Aguilar*, it warned,

[w]e do not acknowledge, and we do not hold, that other courts should conclude our more recent cases have, by implication, overruled an earlier precedent. We reaffirm that "if a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, the Court of Appeals should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions."<sup>105</sup>

Hence, at one level, the Sixth Circuit was correct to reserve the "new" question of whether vouchers are constitutional, given its inability to navigate effectively the Supreme Court's evolved Establishment Clause jurisprudence.

Nonetheless, the Sixth Circuit's decision was plainly erroneous. This Article's analysis of the Supreme Court's jurisprudence on the Establishment Clause demonstrates that where state funds flow to religious institutions via neutral, generally applicable programs, the First Amendment's Establishment Clause is not offended, particularly if the funds are directed by the independent, private decisions of third parties. In addition to ignoring the Supreme Court's more recent jurisprudence, the Sixth Circuit missed the Supreme Court's repeated admonition, first made in *Mueller*, that

[w]e would be loath to adopt a rule grounding the constitutionality of a facially neutral law on annual reports reciting the extent to which various classes of private citizens claimed benefits under the law. Such an approach would scarcely provide the certainty that this field stands in need of, nor can we perceive principled standards by which such statistical evidence might be evaluated. Moreover, the fact that private persons fail in a particular year to claim the tax relief to which they are entitled—under a facially neutral statute—should be of little importance

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104. All a public school has to do to register is "notif[y] the state superintendent prior to the first day in March that the district intends to admit students from the pilot project district for the ensuing school year . . . ." OHIO REV. CODE ANN. § 3313.976(C) (Anderson 1999).

105. *Agostini v. Felton*, 521 U.S. 203, 237 (1997) (citation omitted).

in determining the constitutionality of the statute permitting such relief.<sup>106</sup>

The Supreme Court's determination to avoid making constitutional decisions based upon the number of people of a certain class who take advantage of neutral, generally applicable programs, clearly undercuts the Sixth Circuit's central thesis that, because most students chose religious schools, the program itself must be designed to foster that outcome. Based upon the Supreme Court's recent Establishment Clause jurisprudence, a model voucher program should pass constitutional muster if the state funds flow to religious institutions via neutral, generally applicable programs and if those funds are directed by the independent, private decisions of third parties. The Sixth Circuit's decision in *Simmons-Harris* ignores the Supreme Court's mature Establishment Clause jurisprudence and is thus erroneous.

### III. VOUCHERS AND THE INDIANA STATE CONSTITUTION

The question of whether a model voucher program is constitutional under the Indiana State Constitution is a complicated one. As noted *supra*, this question is wholly separate from the question of whether a model voucher program is a desirable or well-reasoned solution to Indiana's educational woes. To reach this Article's conclusion that a model voucher program is constitutional under Indiana law, Part III considers four separate sources. First, this section examines whether Indiana will develop its own jurisprudence on state funding of religious schools or simply conclude that Indiana's constitution is coextensive with the federal Constitution. Next, this section reviews both Indiana's constitutional history and the history of the Blaine Amendment. Finally, this section investigates Indiana's own jurisprudence on state funding of religious organizations with the cases of *State ex rel. Johnson v. Boyd*<sup>107</sup> and *Center Township of Marion County v. Coe*.<sup>108</sup> We turn first to the question of which standard the Indiana Supreme Court will employ.

#### A. Whether a State or Federal Standard

Some courts, such as the Maine Supreme Judicial Court, have concluded that their constitutional provisions regarding the separation of church and state are coextensive with the First Amendment of the U.S. Constitution.<sup>109</sup> The Indiana

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106. *Mueller v. Allen*, 463 U.S. 388, 401 (1983).

107. 28 N.E.2d 256 (Ind. 1940).

108. 572 N.E.2d 1350 (Ind. Ct. App. 1991).

109. See *Bagley v. Raymond Sch. Dep't*, 728 A.2d 127, 132 (Me. 1999); see also *Bd. of Educ. v. Bakalis*, 299 N.E.2d 737 (Ill. 1973). The Supreme Court of Illinois thought that article X, section 3 of the Illinois Constitution imposed identical restrictions to the First Amendment's Establishment Clause. Article X, section 3 provides:

Neither the General Assembly nor any county, city, town, township, school district, or other public corporation, shall ever make any appropriation or pay from any public fund



Supreme Court is not such a court. In the last decade, the Indiana Supreme Court has developed a growing and independent body of jurisprudence based on the Indiana State Constitution. Hence, in *Collins v. Day*,<sup>110</sup> the Indiana Supreme Court noted that while it occasionally looked to federal case law to address certain questions of state law, it was free to “form[] an independent standard for analyzing state constitutional claims.”<sup>111</sup> Indeed, in *Collins*, the Indiana Supreme Court determined that “claims alleging special privileges or immunities under Indiana section 23 should be given independent interpretation and application.”<sup>112</sup> This accords with Chief Justice Shepard’s observation that Indiana courts have often charted their own way when interpreting the Indiana State Constitution.<sup>113</sup> The Indiana Supreme Court recently followed this practice in *City Chapel Evangelical Free, Inc. v. City of South Bend*.<sup>114</sup>

In *City Chapel*, the Indiana Supreme Court added to the sparse jurisprudence on article I, sections 4 and 6, and clarified that it would not conclude these provisions to be coextensive with the federal constitution. The court observed that

[w]hen Indiana’s present constitution was adopted in 1851, the framers who drafted it and the voters who ratified it did not copy or paraphrase the 1791 language of the federal First Amendment. Instead, they adopted seven separate and specific provisions, Sections 2 through 8 of Article I, relating to religion.<sup>115</sup>

The Indiana Supreme Court held that

the religious liberty provisions of the Indiana Constitution were not intended merely to mirror the federal First Amendment. *We reject the contention that the Indiana Constitution’s guarantees of religious protection should be equated with those of its federal counterpart and*

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whatever, anything in aid of any church or sectarian purpose, or to help support or sustain any school, academy, seminary, college, university, or other literary or scientific institution, controlled by any church or sectarian denomination whatever; nor shall any grant or donation of land, money, or other personal property ever be made by the State, or any such public corporation, to any church, or for any sectarian purpose.

ILL. CONST., art. X, § 3.

110. 644 N.E.2d 72 (Ind. 1994).

111. *Id.* at 75.

112. *Id.*

113. See Randall T. Shepard, *Second Wind for the Indiana Bill of Rights*, 22 IND. L. REV. 575 (1989). Justice Brennan introduced the idea that states might forge their own jurisprudence through their state bill of rights. See William J. Brennan, Jr., *State Constitutions and the Protections of Individual Rights*, 90 HARV. L. REV. 489 (1977); William J. Brennan, Jr., *The Bill of Rights and the States: The Revival of State Constitutions as Guardians of Individual Rights*, 61 N.Y.U. L. REV. 535 (1986).

114. 744 N.E.2d 443 (Ind. 2001).

115. *Id.* at 445-46.

*that federal jurisprudence therefore governs the interpretation of our state guarantees.*<sup>116</sup>

The Indiana Supreme Court has thus clearly stated its determination to forge its own jurisprudence with respect to the Indiana Constitution in general and the religious liberty provisions in particular. Though in *City Chapel* the court did not set forth tests or substantive law regarding sections 4 and 6, it did provide insight into how it would develop such jurisprudence. One of the sources the court inevitably will return to, as it did in *City Chapel*,<sup>117</sup> is the state's history and, specifically, the history of the 1851 Constitution.

### *B. History*

A recitation of Indiana's constitutional history is not merely an esoteric exercise. The Indiana Supreme Court has frequently turned to history to inform its decisions on questions of constitutional law. In *Collins*, the court observed that "[p]roperly interpreting a particular provision of the Indiana Constitution involves a search for the common understanding of both those who framed it and those who ratified it."<sup>118</sup> In *Bayh v. Sonnenburg*,<sup>119</sup> the court explained the role of history further and noted that

in placing a construction upon a constitution or any clause or part thereof, a court should look to the history of the times and examine the state of things existing when the constitution or any part thereof was framed and adopted, to ascertain the old law, the mischief, and the remedy.<sup>120</sup>

Finally, Chief Justice Shepard summed up the proper analysis of the Indiana State Constitution in *Price v. State*<sup>121</sup> when he noted that "[i]nterpretation of the Indiana Constitution is controlled by the text itself, illuminated by history and by the purpose and structure of our constitution and the case law surrounding it."<sup>122</sup> This is all the more true when there is relatively little jurisprudence on the subject. In the case of the constitutionality of voucher programs, not only are there no cases considering this specific issue, there are very few cases that interpret article I, sections 4 and 6 at all. This makes it extremely likely that the Indiana Supreme Court will turn to history when deciding whether vouchers are constitutional under article I, sections 4 and 6.

In one of its longest treatments of the religion clauses, the Indiana Supreme Court recently provided an illustration of the importance that history will play should the issue of student vouchers appear before it. In *City Chapel*, the Indiana

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116. *Id.* at 446 (emphasis added).

117. *See id.* at 448.

118. *Collins v. Day*, 644 N.E.2d 72, 75-76 (Ind. 1994) (citation omitted).

119. 573 N.E.2d 398 (Ind. 1991).

120. *Id.* at 412 (quoting *State v. Gibson*, 36 Ind. 389, 391 (1871)).

121. 622 N.E.2d 954 (Ind. 1993).

122. *Id.* at 957 (citation omitted).



Supreme Court turned to history and in addition to examining the history of the 1851 Constitution, looked as far back as the eighteenth century to

conclude that the framers and ratifiers of the Indiana Constitution's religious liberty clauses did not intend to afford only narrow protection for a person's internal thoughts and private practices of religion and conscience. By protecting the right to worship according to the dictates of conscience and the rights freely to exercise religious opinion and to act in accord with personal conscience, Sections 2 and 3 advance core values that restrain government interference with the practice of religious worship, both in private and in community with other persons.<sup>123</sup>

Though the court declined to delineate the boundaries of article I, sections 2 through 8, *City Chapel* provides persuasive evidence that the Indiana Supreme Court will turn to history to determine whether a model voucher program offends sections 4 and 6. Because the Indiana Supreme Court will consider Indiana's constitutional history, this Article now turns to the 1816 and 1851 Constitutions and an analysis of these documents.

1. *1816 Constitution*.—The 1816 Constitution is important primarily because of the changes that were made when the 1851 Constitution was adopted. The changes that are relevant to this Article are principally two-fold and concern the revision of article IX of the 1816 Constitution, concerning education, and the addition of article I, section 6 to the 1851 Constitution, concerning aid to religious institutions. The 1816 Constitution's provision regarding freedom of religion and the separation of church and state provided:

That all men have a natural and indefeasible right to worship Almighty God, according to the dictates of their own consciences: That no man shall be compelled to attend, erect, or support any place of Worship, or to maintain any ministry against his consent: That no human authority can, in any case whatever, control or interfere with the rights of conscience: And that no preference shall ever be given by law to any religious societies, or modes of worship; and no religious test shall be required as a qualification to any office of trust or profit.<sup>124</sup>

In addition to this fairly typical provision,<sup>125</sup> the 1816 Constitution featured a unique provision concerning education. Article IX set out an unusually ambitious statement of Indiana's belief in the importance of education that

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123. *City Chapel Evangelical Free, Inc. v. City of South Bend*, 744 N.E.2d 433, 450 (Ind. 2001).

124. IND. CONST. of 1816, art. I, § 3.

125. See John D. Barnhart, *Sources of Indiana's First Constitution*, 39 IND. MAG. HIST. 55 (1943). This provision was borrowed from the Kentucky Constitution of 1792. See KEN. CONST. of 1792, art. XII, § 3. Delaware, New Hampshire, Ohio, Pennsylvania, and Vermont also had similar provisions. See DEL. DECL. RIGHTS of 1776, § 2; N.H. CONST. of 1783, art. V; OHIO CONST. of 1802, art. VIII, § 3; PENN. DECL. RIGHTS of 1776, § 2; VT. CONST. of 1777, ch. I, § 3.

purported to establish a strong commitment to a general system of education.<sup>126</sup> Article IX, in relevant part, provided:

Sect. 1. Knowledge and learning generally diffused, through a community, being essential to the preservation of a free Government, and spreading the opportunities, and advantages of education through the various parts of the Country, being highly conducive to this end, it shall be the duty of the General Assembly to provide, by law, for the improvement of such lands as are, or hereafter may be granted, by the united States to this state, for the use of schools, and to apply any funds which may be raised from such lands, or from any other quarters to the accomplishment of the grand object for which they are or may be intended. But no lands granted for the use of schools or seminaries of learning shall be sold by authority of this state, prior to the year eighteen hundred and twenty; and the monies which may be raised out of the sale of any such lands, or otherwise obtained for the purposes aforesaid, shall be and remain a fund for the exclusive purpose of promoting the interest of Literature, and the sciences, and for the support of seminaries and public schools . . . .<sup>127</sup>

Sect. 2. It shall be the duty of the General assembly, *as soon as circumstances will permit*, to provide, by law, for a general system of education, ascending in a regular gradation, from township schools to a state university, wherein tuition shall be gratis, and equally open to all.<sup>128</sup>

Sect. 3. And for the Promotion of such salutary end, the money which shall be paid, as an equivalent, by persons exempt from militia duty except, in times of war, shall be exclusively, and in equal proportion, applied to the support of County seminaries; also all fines assessed for any breach of the penal laws, shall be applied to said seminaries, in the Counties wherein they shall be assessed.<sup>129</sup>

These provisions raise three important issues. First, the provisions show that Indiana recognized early on the importance of education to the general well-being of society. However, as is apparent from the face of article IX, section 2, though the recognition was real, it was, to a certain extent, merely hortatory. By qualifying section 2 with the language “as soon as circumstances will permit,” the framers gave the General Assembly an opt-out provision, which meant that, effectively, no general system was established under the 1816 Constitution.

Second, these provisions make it clear that seminaries were a major

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126. Borrowed in part from the Northwest Ordinance that governed the state prior to 1816. See *An Ordinance for the Government of the Territory of the United States Northwest of the River Ohio*, in CHARLES KETTLEBOROUGH, 1 CONSTITUTION MAKING IN INDIANA 26, 31-32 (1916).

127. IND. CONST. of 1816, art. IX, § 1.

128. IND. CONST. of 1816, art. IX, § 2 (emphasis added).

129. IND. CONST. of 1816, art. IX, § 3.



ingredient in Indiana's educational system. In fact, with no general system of schools established by the legislature, the seminaries and other local schools were *the* major ingredient in the state's education system. In its current usage, the word seminary refers to a school for the training of clergy or priests. However, this was not the meaning of the word in the 1816 Constitution. Rather, under the 1816 Constitution, the precise meaning of "seminaries" was "a school or place of education."<sup>130</sup> The resulting schools might be either religious or secular.

Third, article IX, section 3 makes it clear that these institutions were funded directly by the state through fines and other official sources of revenue. However, because the references to seminaries refer only to schools in general, and not to religious schools in particular, it is clear that article IX, section 3 was not a method for funneling state funds to religious organizations. Although some of the schools that were established under this system were religious, many were not.<sup>131</sup>

These three points are relevant primarily because they were either changed or dropped by the 1851 Constitution because the system did not work. Because article IX, section 2 created a loophole, requiring only that the General Assembly provide a general school system "as soon as circumstances will permit," Indiana never developed a general system of schools and quite a number of children went without any education. This was a point of contention for many citizens who were concerned about Indiana's future.<sup>132</sup>

2. *Changes Instituted by the 1851 Constitution.*—The 1851 Constitution made several changes to the provisions regarding education and the separation of church and state. First, article I, section 3 of the 1816 Constitution was broken up into four separate sections which provide:

Section 2. All people shall be secured in the natural right to worship ALMIGHTY GOD, according to the dictates of their own consciences.

Section 3. No law shall, in any case whatever, control the free exercise and enjoyment of religious opinions, or interfere with the rights of conscience.

Section 4. No preference shall be given, by law, to any creed, religious

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130. See 3 BOUVIER'S LAW DICTIONARY 3041 (8th ed. 1914) ("Seminary. A place of education. Any school, academy, college, or university in which young persons are instructed in the several branches of learning which may qualify them for their future employments."); BLACK'S LAW DICTIONARY 1365 (7th ed. 1999) ("Seminary. 1. An educational institution, such as a college, academy, or other school."); 14 OXFORD ENGLISH DICTIONARY 956 (1991) ("seminary . . . 4. A place of education, a school, college, university, or the like.").

131. See RICHARD G. BOONE, A HISTORY OF EDUCATION IN INDIANA, chs. 5-7 (Indiana Historical Society 1941) (1892) (examining and occasionally listing all the "seminaries" existing from time to time).

132. See discussion *infra* Part III.B.3.

society, or mode of worship; and no person shall be compelled to attend, erect, or support, any place of worship, or to maintain any ministry, against his consent.

Section 5. No religious test shall be required as a qualification for any office of trust or profit.<sup>133</sup>

The Constitution also added a provision concerning the competence of witnesses, which provides that “[n]o person shall be rendered incompetent as a witness, in consequence of his opinions on matters of religion.”<sup>134</sup> For purposes of this Article, the addition of article I, section 6, which was borrowed from the Wisconsin and Michigan constitutions,<sup>135</sup> is by far the most important change. Section 6 provides that “[n]o money shall be drawn from the treasury, for the benefit of any religious or theological institution.”<sup>136</sup>

With regard to education, article IX of the 1816 Constitution was rewritten to remove the loophole and place an affirmative duty upon the General Assembly “to provide, by law, for a general and uniform system of Common Schools, wherein tuition shall be without charge, and equally open to all.”<sup>137</sup> The 1851 Constitution also provided for a common school fund “to be derived from the sale of County Seminaries, and the moneys and property heretofore held for such Seminaries . . . .”<sup>138</sup> The money from county fines and fees paid in lieu of militia service were, needless to say, no longer to go to the County Seminaries. In short, the 1851 Constitution abandoned the rather informal education system set out by the 1816 Constitution in favor of the “general and uniform system of Common Schools,” that, from the beginning, was Indiana’s objective.

3. *Historical Analysis.*—It would be tempting to conclude that the changes made regarding education and support of religious schools in the 1851 Constitution were the result of a strong aversion to the funding of such schools and a renewed understanding of what true separation of church and state required. This would be a mistake, however, and would reflect an imperfect understanding of both the 1816 Constitution and the societal changes that brought about the 1851 Constitution. First, as noted *supra*,<sup>139</sup> the 1816 Constitution’s reference to seminaries must be read to mean simply schools, as it was understood to mean at the time. Thus, the dismantling of the seminary system connotes no special view of the funding of religious schools. Second, the major changes made in the 1851 Constitution arose out of several crises that confronted Indiana at mid-century. The first, and best known crisis is attending

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133. IND. CONST. art. I, §§ 2-5 (sections 2 and 4 were amended in 1984).

134. IND. CONST. art. I, § 7.

135. See JOURNAL OF THE CONVENTION OF THE PEOPLE OF THE STATE OF INDIANA TO AMEND THE CONSTITUTION 964 (1851).

136. IND. CONST. art. I, § 6.

137. IND. CONST. art. VIII, § 1.

138. IND. CONST. art. VIII, § 2, cl. 5.

139. See *supra* note 130 and accompanying text.



failure of the Internal Improvements System of 1836. The second crisis was Indiana's failure to establish a system for general education, which meant that by mid-century, the majority of Indiana's children were receiving no education at all.<sup>140</sup>

In the first instance, Indiana's Internal Improvement System of 1836 proved to be a large-scale disaster deemed "a catastrophic fiscal debacle,"<sup>141</sup> that left the state bankrupt.<sup>142</sup> In 1836, Indiana embarked on a series of internal improvements that it believed would help to develop its economy and allow it to participate in the Industrial Revolution. The majority of these improvements concerned transportation. By the 1830s Indianapolis was an "almost inaccessible village"<sup>143</sup> and the roads (such as they were) presented a real danger to anyone traveling on them.<sup>144</sup> Without a transportation system, many feared that Indiana would be left behind, unable to move its agricultural and manufactured goods to market. The Internal Improvement System of 1836 was, at its roots, an attempt to build such a system, consisting of roads, turnpikes, canals, and railroads. Indiana was quite optimistic that the funds for such a system could be raised through bonds and the sale of federal land grants. Indiana was also confident that the borrowed monies could be repaid through the revenue garnered from the turnpikes, canals, and railroads. It is enough to say that it failed miserably and, in hindsight, historians have described the plan as a "giddy speculative course."<sup>145</sup> By 1841, Indiana defaulted on some \$15.1 million in debt (\$3.6 million of which was never paid to the state) and the interest on its debts alone exceeded the state's annual income by several times; in fact, prior to the default, the state was forced to pay the interest on its debts by issuing more bonds.<sup>146</sup> The

140. DONALD F. CARMONY, *INDIANA, 1816-1850: THE PIONEER ERA* 379 (1998) (noting that the state treasurer concluded that "roughly 64 percent of [school age children] had been without 'any benefit of common school instruction' the preceding year"). See generally BOONE, *supra* note 131 (the first half of Boone's work is a catalog of horrors regarding the state of education in Indiana before 1851).

141. CARMONY, *supra* note 140, at 241.

142. See *Collins v. Day*, 644 N.E.2d 72, 76 (Ind. 1994).

The constitutional convention met in late 1850 and early 1851 against a backdrop of problems associated with states' efforts to develop their infrastructures and stimulate economic progress. Beginning in 1836, the State of Indiana had engaged in a general system of internal improvements, issuing bonds which were then sold in the market at a heavy discount, with the resulting money "squandered on various railroads and canals," none of which were completed.

*Id.* (quoting *Lafayette, Muncie & Bloomington R.R. v. Geiger*, 34 Ind. 185, 205 (1870)). Though the Erie-Wabash Canal was eventually completed it was a commercial failure; railroads were in the ascendancy by the time it became operative.

143. CARMONY, *supra* note 140, at 175.

144. *Id.*

145. RAY ALLEN BILLINGTON, *WESTWARD EXPANSION: A HISTORY OF THE AMERICAN FRONTIER* 343 (1949).

146. See CARMONY, *supra* note 140, at 226-29.

situation was so dire that, in early 1841, Rothschild & Sons petitioned President William Henry Harrison to help the state avoid default on its debts.<sup>147</sup> The Whig Party, which was in power when the plan was adopted, eventually admitted that "Indiana is a ruined state."<sup>148</sup> Not only was Indiana bankrupt, but few of the projects were either completed or ever became profitable.

Indiana's fiscal collapse was the major impetus behind the 1851 Constitution and its changes to the 1816 Constitution.<sup>149</sup> In some ways, it was also the cause of changes made to the 1816 Constitution's provisions on education. First, the state, bankrupt as it was, could hardly afford to make use of the admittedly inefficient and incomplete private school system. There was considerable thought in the years before 1851 that a common school system would be less expensive than the then existing system.<sup>150</sup> Moreover, the common schools would be free to all. Second, by the late 1840s there was a widespread disaffection with the specialized legislation and various privileges granted by the legislature.<sup>151</sup> This disaffection extended to the county seminaries as well,<sup>152</sup> which were often financed by the interest on loans and in some cases mismanaged; by 1851 they were fairly unpopular.<sup>153</sup> To a certain extent, the county seminaries fell by the same axe that cut out debt financing and special legislation from the 1816 Constitution as a whole.<sup>154</sup> This situation was

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147. *See id.* at 229; *see also* NIALL FERGUSON, *THE HOUSE OF ROTHSCHILD: MONEY'S PROPHETS 1798-1848* 372-75 (1998).

148. CARMONY, *supra* note 140, at 230; *accord* Collins, 644 N.E.2d at 76 ("The bonds greatly depreciated in value, the state's credit 'was utterly ruined in the money market,' and the state abandoned the completion of the improvement projects in 1842." (quoting Lafayette, Muncie & Bloomington R.R. v. Geiger, 34 Ind. 185, 205 (1870))).

149. Even within the 1851 Constitution this is evident. For instance, article XIII has only one section, which limits debt to two percent of any political or municipal corporation's property value. IND. CONST. art. XIII, § 1.

150. *See* CARMONY, *supra* note 140, at 385.

151. *See* Collins, at 76-77 (noting that much of the debate during the convention focused on the state's fiscal collapse and the granting of privileges and monopolies). *See also* KETTLEBOROUGH, *supra* note 126, at lxxii (In 1848, "Governor Whitcomb called attention to the growing evils of local and special legislation, its injustice to individual interests, its expense to the treasury, and the undue consumption of time employed in the consideration of private legislation.").

152. *See* CARMONY, *supra* note 140, at 395; *see also* KETTLEBOROUGH, *supra* note 126, at cxlvi.

153. *See* BOONE, *supra* note 131, at 38, 43-44.

154. An interesting corollary is provided by the Ohio Constitution. Like Indiana, Ohio drew much from the Northwest Ordinance that governed the territories before statehood. Indiana was not the only midwest state to experience spectacular internal improvement failures; Ohio, Illinois, and Michigan also participated in the frenzy. *See, e.g.,* 2 R. CARLYLE BULEY, *THE OLD NORTHWEST: PIONEER PERIOD, 1815-1840*, ch. 2 "Economic History" (1950). Perhaps in response to its own economic failure, but certainly in response to the overweening power of the legislature, the Ohio constitution was also rewritten in 1851. *See* Frederick Woodbridge, *A History of*



compounded by Indiana's other mid-century crisis.

Notwithstanding the precatory language in the 1816 Constitution, Indiana failed to institute a comprehensive and workable system for educating its children.<sup>155</sup> The situation was such that Caleb Mills,<sup>156</sup> a founder of Wabash College, concluded that Indiana residents

are the most ignorant of the *free States*, and are far below even some of the *Slave States*. *One-seventh part* of our adult population are unable to read the word of God, or write their names. Some of our counties are enveloped in an thicker intellectual darkness than shrouds *any State* in the Union.<sup>157</sup>

The local system was quite haphazard, expensive, and altogether absent in some

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*Separation of Powers in Ohio: A Study in Administrative Law*, 13 U. CIN. L. REV. 191, 218-20 (1939). The changes made to the Ohio Constitution included new provisions on the funding of sectarian schools. The changes were made in response to problems in Ohio similar to those experienced in Indiana. By mid-century, Ohio had little in the way of an educational system and many children went without instruction. Like Indiana, Ohio's education system was haphazard and disorganized.

The result was a mass of confused facts and conflicting legislation that as it multiplied left the legislators themselves in ignorance as to the exact law that applied in particular cases. Opportunities for carelessness and downright dishonesty in the local handling of the funds and the selling and leasing of the lands were afforded, and, as the records show, not all local officials were either careful or honest.

EDWARD ALANSON MILLER, *THE HISTORY OF EDUCATIONAL LEGISLATION IN OHIO FROM 1803-1850*, at 116 (1969). Ohio's article VI, § 2 is a response to similar problems with debt financing, specialized legislation, and a haphazard school system. Ohio's response, however, was more precise than Indiana's, providing that "no religious or other sect, or sects, shall ever have any exclusive right to, or control of, any part of the school funds of this state." OHIO CONST. art. VI, § 2. This phrasing, with its obvious concern about individual groups' gaining control of state funds, responded more precisely to the overarching worries of the citizens of the states, whose governments and private interests had directed them on a dangerous and speculative course, resulting in bankruptcy for many. It was also part of a reasoned reassessment, at mid-century, about the best way in which to educate the children of the state. By 1850, it was quite apparent to Ohio and Indiana residents that haphazard and voluntary systems would not get the job done.

155. See BOONE, *supra* note 131, at 22 ("From all this, however, came neither a system of schools nor any individual teaching of note.").

156. Richard Boone said that Professor Mills "did more for general education in Indiana than any other one man." *Id.* at 62.

157. CARMONY, *supra* note 140, at 387-88 (emphasis in original). According to the census of 1840, 14.3% of Indiana residents were illiterate (at the bottom of the list were Tennessee and North Carolina where illiteracy was 23.5% and twenty-seven percent respectively). However, there is reason to believe that the situation was worse in some segments of the population. If one considers the data from each county, Indiana's illiteracy rate for persons over twenty years of age was twenty-eight and more than forty percent in some parts of the state. BOONE, *supra* note 131, at 88-89.

places.<sup>158</sup> With this in mind, the 1851 Constitution mandated a common school system that would be free to all (of the white population) and available throughout the state.

Thus, it is not possible to ascribe the changes instituted by the 1851 Constitution to a desire to prohibit public funding of religious schools. The motivation behind the changes in the 1851 Constitution and Indiana's adoption of a common school system were principally three-fold and in no way preclude a model voucher system. First, the 1851 changes were a reaction to the failure of Indiana's voluntary, private, and local school system.<sup>159</sup> Second, they were a reaction to Indiana's fiscal collapse and a desire to accomplish more schooling in a less-expensive fashion. Finally, the changes were part of the larger desire to do away with special and local legislation in favor of generalized legislation.<sup>160</sup> A model voucher program offends none of these criteria.

One question remains. What is to be made of the addition of article I, section 6? As shown *infra*,<sup>161</sup> article I, section 6 is an establishment clause provision that works in tandem with section 4 to prohibit the payment of public funds to religious organizations where those funds are used for religious purposes.

### C. *Is Article I, Section 6 a Blaine Amendment?*

The Blaine Amendment has attracted considerable attention in the last several years.<sup>162</sup> It is the subject of much thought and some misunderstanding. James G. Blaine and his proposed amendment to the U.S. Constitution are proper subjects of inquiry as part of any consideration of the constitutionality of a student voucher program. Nonetheless, with respect to Indiana, it must be immediately understood and articulated that article I, section 6 is not a Blaine amendment.<sup>163</sup> Indiana's 1851 Constitution was enacted nearly a quarter-century

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158. See BOONE, *supra* note 131, at 42-49.

159. As noted *supra*, since the references to seminaries in the 1816 Constitution were to schools in general, the 1851 changes were not a rejection of funding for religious schools.

160. See *Collins v. Day*, 644 N.E.2d 72, 76-77 (Ind. 1994).

161. See discussion *infra* Part III.D.

162. See, e.g., Steven K. Green, *The Blaine Amendment Reconsidered*, 36 AM. J. LEGAL HIST. 38 (1992); Frank R. Kemerer, *The Constitutional Dimension of School Vouchers*, 3 TEX. F. ON C.L. & C.R. 137 (1998); Joseph P. Viteritti, *Blaine's Wake: School Choice, the First Amendment, and State Constitutional Law*, 21 HARV. J.L. & PUB. POL'Y 657 (1998) [hereinafter Viteritti, *Blaine's Wake*]; Joseph P. Viteritti, *Choosing Equality: Religious Freedom and Educational Opportunity Under Constitutional Federalism*, 15 YALE L. & POL'Y REV. 113 (1996); Toby J. Heytens, Note, *School Choice and State Constitutions*, 86 VA. L. REV. 117, 140 (2000).

163. Though not Blaine-era provisions, whether article I, sections 4 and 6 were the product of the same anti-Catholic sentiment that gave rise to the Blaine Amendment, is a somewhat murky issue. The weight of the evidence suggests that the provisions were not the product of such sentiment. Nativism and the Know-Nothing Party came to Indiana after the 1851 Constitution was adopted and after the Whig Party's downfall in 1852. EMMA LOU THORNBROUGH, *INDIANA IN THE CIVIL WAR ERA: 1850-1880*, at 60-61 (reprint 1989) (1966). Specifically, L.C. Rudolph dates



before then Governor Rutherford B. Hayes of Ohio and Representative James G. Blaine began to publicly oppose the use of state funds to support Catholic schools in 1875.

Though the personal history of Blaine is an unusual one,<sup>164</sup> the history of his amendment is well understood. By 1850, Roman Catholics were the largest denomination in the United States<sup>165</sup> and, following the Civil War, they began to develop separate schools and to seek state funds for those schools.<sup>166</sup> In the early

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Know Nothingism's arrival to shortly after Alessandro Gavazzi was invited to speak in Indianapolis in October 1853. L.C. RUDOLPH, *HOOSIER FAITHS: A HISTORY OF INDIANA'S CHURCHES AND RELIGIOUS GROUPS* 546 (1995). In any event, by 1854, the Know Nothing Party was a political force in the state. THORNBROUGH, *supra*, at 61. Though Nativism and the Know Nothing Party had no real claim for originality with their anti-immigrant and anti-Catholic sentiment, the message had little political appeal in the east until the late 1840s and several years later in Indiana (which is not to say there was no anti-Catholicism, especially in the east, before the 1840s as Ray Allen Billington conclusively demonstrates otherwise). The growth of nativism and the Know Nothing Party in Indiana coincided with the rapid growth of the Roman Catholic and immigrant populations in Indiana after 1850. *Id.* at 634. Tyler Anbinder concurs with this analysis, noting that by 1850, under six percent of Indiana's inhabitants were immigrants and says, "Indiana possessed few immigrants and even fewer Catholics. Nativism flourished there in part because the Indiana constitution permitted every resident to vote, including those who had not yet acquired American citizenship." TYLER ANBINDER, *NATIVISM AND SLAVERY: THE NORTHERN KNOW NOTHINGS AND THE POLITICS OF THE 1850S*, at 71 (1992). Anbinder observes that in Indiana, the Know Nothings included other issues in their political agenda, such as temperance and abolition, making Hoosier Know Nothingism somewhat less virulent. Anbinder concludes that, "[i]n Indiana, Know Nothingism clearly became the focal point for issues other than nativism." *Id.* at 72. A related question is whether and to what extent the common school movement as a whole was an anti-Catholic attempt to reinforce Protestant values. See, e.g., Richard W. Garnett, *Brown's Promise, Blaine's Legacy*, 17 CONST. COMMENT. 651 (2000) (book review). With respect to Indiana, it is important to note that the common school movement was driven largely by Protestant forces. Still, in Indiana, it was not simply Catholics that were absent from the debates. "Quakers; strict adherents to certain elements among the Presbyterians, Methodists, and Baptists; and others" were absent from the debates. CARMONY, *supra* note 140, at 378. In *Kotterman v. Killian*, 972 P.2d 606, 624-626 (Ariz. 1999), Arizona examined its own history and rejected the argument that its article II, section 12 was a Blaine Amendment, notwithstanding section 12's similarity to a provision in the Washington Constitution that was a Blaine Amendment. The court noted section 12's similarity to Indiana's article I, section 6. See *id.* at 625; *infra* note 177. For a discussion of anti-Catholicism and nativism, in general, see RAY ALLEN BILLINGTON, *THE PROTESTANT CRUSADE, 1800-1860: A STUDY OF THE ORIGINS OF AMERICAN NATIVISM* (1938); JODY M. ROY, *NINETEENTH-CENTURY AMERICAN ANTI-CATHOLICISM AND THE CATHOLIC RESPONSE* (1997) (unpublished Ph.D. Dissertation, Indiana University) (on file with author).

164. A useful introduction to the life and career of James G. Blaine can be found in Oxford University Press' *American National Biography*. 2 AMERICAN NATIONAL BIOGRAPHY 902 (1999).

165. MICHAEL S. ARIENS & ROBERT A. DESTRO, *RELIGIOUS LIBERTY IN A PLURALISTIC SOCIETY* 165 (1996).

166. Green, *supra* note 162, at 43. Green notes that in 1871, *Harper's Weekly* reported that

1870s, Catholics began a high profile campaign challenging the Protestant orthodoxy then prevailing in most common school systems.<sup>167</sup> These efforts included attempts, some of which were successful, to remove the King James Bible from public schools and to obtain funds for parochial schools.<sup>168</sup> By 1875, the stage was set for a bitter fight over the fate of religion in the nation's schools. That year, the Republicans seized the issue and hoped to use it to their advantage during the upcoming election.<sup>169</sup> Governor Hayes first voiced the party's opposition to state funds for Catholic schools and President Ulysses S. Grant subsequently took up the cause. Representative James G. Blaine, deposed Speaker of the House and Republican presidential hopeful, eventually proposed the following amendment to the United States Constitution, hoping to enhance his prospects for winning the Republican nomination:<sup>170</sup>

No State shall make any law respecting an establishment of religion or prohibiting the free exercise thereof; and no money raised by taxation in any State for the support of public schools, or derived from any public fund therefor, nor any public lands devoted thereto, shall ever be under the control of any religious sect; nor shall any money so raised or lands so devoted be divided between religious sects or denominations.<sup>171</sup>

The amendment passed the House but a different version failed to earn the two-thirds majority needed in the Senate. By the time the amendment reached the Senate, Hayes had been selected as the Republican nominee and Blaine had been appointed a Senator from Maine. Having lost the presidential nomination for President, Blaine lost interest in the amendment and neither participated in the Senate debates nor voted on the amendment.<sup>172</sup> Blaine was the Republican nominee for President in 1884 but lost New York to Grover Cleveland, by 1149

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the Catholic Diocese of New York City had received \$700,000 and that, even after a state ban on the practice, the diocese received \$370,000 in 1875. *Id.*

167. *Id.* at 42-44.

168. *See id.* at 42-47.

169. *See* Marie Carolyn Klinkhamer, *The Blaine Amendment of 1875: Private Motives for Political Action*, 42 CATH. HIST. REV. 15, 19-21 (1957); Green, *supra* note 162, at 47-51; Kemerer, *supra* note 162, at 153-54. The Republicans were dogged by corruption in the White House (the Whiskey Ring) and recent electoral defeats. Following the 1874 election and the loss of a number of congressional seats, Blaine was deposed as the Speaker of the House of Representatives. Green, *supra* note 162, at 49.

170. *See* Klinkhamer, *supra* note 169, at 29-32. Klinkhamer argues that Blaine tried to walk a dangerous tightrope with the issue. She notes that Blaine had close family ties to Catholicism and tried to use the issue to convince both Catholics and Protestants alike that he was not Catholic, which would have ended his presidential ambitions. On one hand, Blaine wanted to convince Catholics that he was not a lapsed Catholic, which they would have viewed with some suspicion. On the other hand, Blaine needed to convince the Protestant majority that, notwithstanding his family ties, he had no Catholic tendencies.

171. 4 CONG. REC. 205 (Dec. 14, 1875).

172. Green, *supra* note 162, at 67-68.



votes, after offending the citizens of New York, especially the Irish-Americans, when he failed to object to a speaker who referred to the Democratic Party as the party of "Rum, Romanism, and Rebellion."<sup>173</sup>

Though the Blaine Amendment was never adopted at the federal level, it was adopted by a number of states, and was even mandated by Congress for some new states.<sup>174</sup> Though some thirty states adopted some version of the amendment, Indiana did not follow suit.<sup>175</sup> As noted, Indiana adopted its article I, section 6 in 1851, nearly a quarter century before the Blaine Amendment was proposed.

That Indiana's article I, section 6 is not a Blaine Amendment is important in two respects. First, unlike the Blaine Amendment, Indiana's article I, section 6 was not "a remnant of nineteenth-century religious bigotry promulgated by nativist political leaders who were alarmed by the growth of immigrant populations and who had a particular disdain for Catholics."<sup>176</sup> Nor was section 6 "a clear manifestation of religious bigotry, part of a crusade manufactured by the contemporary Protestant establishment to counter what was perceived as a growing 'Catholic menace.'"<sup>177</sup> Were section 6 such a provision, it would likely violate the Fourteenth Amendment's Equal Protection Clause by classifying on the basis of religion.<sup>178</sup>

173. See ANSON PHELPS STOKES, 2 CHURCH AND STATE IN THE UNITED STATES 417 (1950).

174. Viteritti, *Blaine's Wake*, *supra* note 162, at 672-73.

175. The exact number (twenty-nine to thirty-three) is a matter of some disagreement. See Heytens, *supra* note 162, at 664 n.32 (explaining the differing opinions and incorrectly listing Indiana as one of the thirty-two states adopting the Blaine Amendment).

176. Viteritti, *Blaine's Wake*, *supra* note 162, at 659; see also Heytens, *supra* note 162, at 140 (Blaine Amendments are "an artifact of the religious tensions that plagued the United States during the later third of the nineteenth century.").

177. *Kotterman v. Killian*, 972 P.2d 606, 624 (Ariz. 1999). The Arizona Supreme Court's description of the Blaine Amendment is particularly important because the court held that Arizona's article II, section 12 and article IX, section 10 were not Blaine Amendments and did not prohibit a tax credit for givers of gifts to organizations that grant scholarships to children who wish to "attend any qualified school of their parents' choice," including religious schools. ARIZ. REV. STAT. § 43-1089.E.3 (1989). This holding is important here because the *Kotterman* court thought that Indiana's article I, section 6 was similar to its own article II, section 12, lending support to the conclusion that article I, section 6 is not a Blaine Amendment.

178. See Garnett, *supra* note 163, at 667-70; Heytens, *supra* note 162, at 140-61; Eugene Volokh, *Equal Treatment Is Not Establishment*, 13 NOTRE DAME J. L. ETHICS & PUB. POL'Y 341 (1999). Equal Protection violations often appear as Free Exercise violations; in fact, the claims overlap and "[a] court considers these claims as one constitutional inquiry." *Columbia Union College v. Clarke*, 159 F.3d 151, 156 n.1 (4th Cir. 1998). See also *Brown v. Borough of Mahaffey*, 35 F.3d 846, 850 (3d Cir. 1994) (noting that Free Exercise and Equal Protection claims were the same except that a plaintiff raising an Equal Protection claim must also show that he or she "received different treatment from other similarly situated individuals or groups."); *Church of Scientology Flag Serv. Org., Inc. v. City of Clearwater*, 2 F.3d 1514, 1529-30 (11th Cir. 1993) (observing the overlap between Free Speech, Free Exercise, and Establishment Clause claims). In

A long line of cases establishes the proposition that the government may not discriminate on the basis of religion. Thus, in *Employment Division v. Smith*,<sup>179</sup> the Court observed that “[t]he government may not . . . impose special disabilities on the basis of religious views or religious status.”<sup>180</sup> Later, in *Church of Lukumi Babalu Aye v. City of Hialeah*,<sup>181</sup> the Court noted that, “[a]t a minimum, the protections of the Free Exercise Clause pertain if the law at issue discriminates against some or all religious beliefs or prohibits conduct because it is undertaken for religious reasons.”<sup>182</sup> The Court has maintained this stance at the intersection of religion and free speech and has repeatedly held that the government may not discriminate based on the religious content of the speech. Most recently, in *Good News Club v. Milford Central School*,<sup>183</sup> the Court reiterated its holdings in *Widmar v. Vincent*,<sup>184</sup> *Lamb’s Chapel v. Center Moriches Union Free School District*,<sup>185</sup> and *Rosenberger v. Rector and Visitors of the University of Virginia*<sup>186</sup> saying, “we hold that the exclusion of the Club on the basis of its religious perspective constitutes unconstitutional viewpoint discrimination. . . .”<sup>187</sup> As Eugene Volokh has usefully demonstrated, the same can be said for the Court’s Establishment Clause jurisprudence in which the “language of evenhandedness” pervades its opinions.<sup>188</sup> Hence, the requirement that the principal or primary effect of government action neither advance nor inhibit religion is merely another way of saying the government may not discriminate in favor of, or against, religion.

Second, because section 6 is not a Blaine Amendment, it is both possible and likely that its purposes are larger.<sup>189</sup> Unlike the Blaine Amendment, which only speaks to the payment of state funds to religious schools, section 6 is, on its face, broader. Thus, section 6 was both a reasoned reaction to the crises confronting Indiana at mid-century and a more general Establishment Clause provision. In

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*Peter v. Wedl*, 155 F.3d 992 (8th Cir. 1998), the Eighth Circuit explicitly found an Equal Protection violation based on a Minnesota law that prohibited schools from providing disability services at a private religious school, where those services were available at public schools and other private schools. The court held that the law “violated the plaintiffs’ rights to free exercise of religion, free speech, and equal protection . . . .” *Id.* at 997.

179. 494 U.S. 872 (1990).

180. *Id.* at 877.

181. 508 U.S. 520 (1993).

182. *Id.* at 532.

183. 121 S. Ct. 2093 (2001).

184. 454 U.S. 263 (1981).

185. 508 U.S. 384 (1993).

186. 515 U.S. 819 (1995).

187. *Good News Club*, 121 S. Ct. at 2100 n.2.

188. Volokh, *supra* note 178, at 365.

189. In fact, during the debates in Congress, the Blaine Amendment was criticized as a narrowly drawn provision that would only prevent states from giving money to parochial schools but would not prevent states from subsidizing the Catholic Church in other ways. See Klinkhamer, *supra* note 169, at 42-46.



light of the Indiana Supreme Court's jurisprudence on sections 4 and 6,<sup>190</sup> these provisions prohibit only the payment of public funds to religious organizations, where those funds are a gift or subsidy to support an organization's religious activities. Thus, sections 4 and 6 work in tandem as an Establishment Clause, concerned with the capture of state funds by religious groups where those funds amount to either gifts or subsidies to advance the group's religious mission.

*D. Indiana's Jurisprudence on Article I, Sections 4 and 6*

The limited case law on sections 4 and 6 consists primarily of *State ex rel. Johnson v. Boyd*<sup>191</sup> and *Center Township of Marion County v. Coe*.<sup>192</sup> These two cases show both that sections 4 and 6 prohibit only the payment of public funds to religious organizations, where those funds are used for religious purposes, and that they work in tandem as an Establishment Clause.

1. *State ex rel. Johnson v. Boyd*.—*Boyd*, together with *Coe*, must be considered as part of a discussion of the constitutionality of a voucher program under the Indiana Constitution. In *Boyd*, taxpayers in Vincennes, Indiana, sued the city's treasurer, alleging that public funds had been expended to support several parochial schools from 1933 to 1937. The taxpayers argued that this practice violated article I, sections 4 and 6, and that the funds must be returned. *Boyd* arose after the Roman Catholic parish in Vincennes determined that, beginning in the fall of 1933, it would no longer be able to operate several parochial schools in the city.<sup>193</sup> The parish asked the city to prepare accommodations for the 800 students who would no longer be able to attend these schools. The school district determined that "the children formerly attending such schools could not . . . be properly cared for in the school buildings owned by the School City . . . ."<sup>194</sup> Having reached that conclusion, the school district found it both "adviseable [sic] and necessary to take over and make a part of the public schools and the school system of this school city the St. Francis Xavier School, St. John School, and Sacred Heart School . . . ."<sup>195</sup>

In furtherance of this policy, the school district directed that the course of study in the schools conform to that used in the city's public schools, the buildings and equipment in these schools would be used by the city, and that "no sectarian instruction shall be permitted during school hours in said schools."<sup>196</sup> To staff the schools, the Superintendent relied on recommendations from several Catholic colleges and, based upon those recommendations, staffed the schools with the "Sisters and Brothers [of] various Catholic orders."<sup>197</sup> These teachers

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190. See discussion *infra*, Part III.D.

191. 28 N.E.2d 256 (Ind. 1940).

192. 572 N.E.2d 1350 (Ind. Ct. App. 1991).

193. *Boyd*, 28 N.E.2d at 260.

194. *Id.* at 261.

195. *Id.*

196. *Id.*

197. *Id.*

were all licensed to teach in Indiana and they taught the course of study prescribed by the city. Though the city used the buildings and equipment owned by the parish, it did not pay for the use of these items. Nor did the city pay for heat, lights, water, fuel, or janitorial service for the buildings. The schools each retained various accessories, usually found in a parochial school, such as pictures of Jesus, the Holy Family, and Holy Water founts. In addition, the teachers wore the garb of the orders to which they belonged, which included crucifixes and rosaries where appropriate. Finally, on the grounds of each school was a Catholic Church that the students in each school voluntarily attended prior to each school day. The students attending these schools were exempted from attending the city school that based on geography, they normally would have attended; instead, they were allowed to attend the Catholic schools that they previously had attended.<sup>198</sup>

The *Boyd* court found that article I, sections 4 and 6 forced them to inquire into whether the city's arrangement amounted to a vehicle for making indirect donations to the church.<sup>199</sup> In developing its test, the court made it fairly clear that these sections are essentially Establishment Clause provisions. Based on this conclusion, the court's analysis focused on whether the schools in question remained, in fact, parochial schools. The Indiana Supreme Court held that the city's practice of operating the schools was not a donation because the schools were in fact public. The court noted that the school district employed

teachers who were regularly licensed to teach school agreeable with the laws of the State of Indiana and with such teachers established schools in the school plants formerly occupied by said parochial schools. These teachers taught the course of study prescribed by the State Board of Education. No sectarian instruction was permitted in said schools during school hours. The schools were visited occasionally by the superintendent of the Vincennes City Schools and frequently by the Director of Instruction in the elementary grades of said city schools. The teachers were paid their salaries from public funds by the treasurer of the school city. In view of these findings it can not [sic] be said that the primary facts found by the court necessarily lead to the conclusion that the schools in question during this period were not public schools or that the salaries paid amounted to contributions made indirectly to parochial schools or to the church.<sup>200</sup>

The court ultimately found that the situation presented no problem under article I, sections 4 and 6; it was not constitutionally suspect for the school district to make use of the parochial school facilities.<sup>201</sup> Nor did the Catholic Church's gratis provision of the buildings and furniture make the operation a private, religious one. The court noted that, "[s]ince the teachers in said schools were

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198. *Id.* at 262.

199. *See id.* at 264.

200. *Id.*

201. *Id.* at 264-65.



employed by the Board of School Trustees, teaching the course prescribed for the public schools, such teachers were the employees of the school city and their possession of said premises was the possession of the school city.”<sup>202</sup> Quite simply, there was no chance of money being drawn from the treasury for the benefit of a religious institution because the schools in question were, in fact, public.

It is safe to say that *Boyd* was a fairly unusual case.<sup>203</sup> Perhaps one key to the court’s decision was its characterization of the situation confronting the Vincennes school district. It is not unusual for courts to permit actions during emergencies that would not otherwise hold.<sup>204</sup> The *Boyd* court repeatedly characterized the situation facing the school district as an emergency. Hence, in the court’s analysis, the school district adopted a reasoned approach to deal with an emergency that threatened its ability to comply with Indiana law. The school district had an affirmative statutory obligation that required it to “employ teachers, establish and locate conveniently a sufficient number of schools for the education of children therein, and build, or otherwise provide, suitable houses, furniture, apparatus and other articles and educational appliances necessary for the thorough organization and efficient management of said schools.”<sup>205</sup> Charged with such a duty, the Indiana Supreme Court thought the Board of Trustees “faced . . . an emergency to provide school facilities for more than 800 additional school children. In the opinion of the trustees they could not be properly cared for in the buildings owned by the school city.”<sup>206</sup> Whether or not *Boyd* would survive today, the case remains important because of what it reveals about the contours of article I, sections 4 and 6.

*Boyd* reveals two particularly relevant things about sections 4 and 6. First, *Boyd* shows that section 6 is not a Blaine Amendment. Were it a Blaine Amendment, the *Boyd* court could not have held that sections 4 and 6 prohibit only donations to religious organizations; as previously discussed, a Blaine Amendment prohibits *all* payments to religious schools.<sup>207</sup>

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202. *Id.* at 265.

203. At least one former Indiana Supreme Court Justice has opined that such an arrangement would not pass muster today. See Remarks of Associate Justice Jon D. Krahulik (ret.) in *Ind. State Const. Law*, Jan. 18, 2000 (on file with author).

204. See, e.g., *Korematsu v. United States*, 323 U.S. 214 (1944) (upholding the internment of Japanese-American civilians, stating that

[c]ompulsory exclusion of large groups of citizens from their homes, except under circumstances of direst emergency and peril, is inconsistent with our basic governmental institutions. But when under conditions of modern warfare our shores are threatened by hostile forces, the power to protect must be commensurate with the threatened danger).

*Id.* at 219-20.

205. *Boyd*, 28 N.E.2d at 264 (citing provisions now codified at IND. CODE § 20-2-9-1(a) (1998)).

206. *Id.*

207. See discussion *supra* Part III.C.

Second, the *Boyd* court interpreted sections 4 and 6 together and did not distinguish between the two provisions when deciding the case and formulating the test that would govern state funding of religious schools. By doing so, the *Boyd* court made it clear that sections 4 and 6 work together and are, at their core, an Establishment Clause. The *Boyd* court noted that it would uphold the City of Vincennes' arrangement, unless the facts showed that the payments made by the city were made to "parochial schools" and were "an indirect payment or donation to the church."<sup>208</sup> The court's words are best understood to prohibit the payment of public funds to religious organizations, where those funds are used for religious purposes. This two-part requirement is key. The *Boyd* court held that merely making payments to a religious entity was not prohibited by the Indiana Constitution. Such payments are only prohibited under sections 4 and 6 when they amount to a "donation to the church," that is, where the payments are not for services rendered but are donations or subsidies to promote the church's religious mission.<sup>209</sup> It is also clear from the *Boyd* court's analysis that a violation can be either direct or indirect.

In *County Department of Public Welfare of Allen County v. Potthoff*,<sup>210</sup> the Indiana Supreme Court reaffirmed its holding in *Boyd* that section 6 works with section 4 as an Establishment Clause. In *Potthoff*, the court observed that article I, section 6 prevented gifts to religious and theological institutions.<sup>211</sup> The Indiana Supreme Court's *Boyd* analysis has been followed in other cases, including *Center Township of Marion County v. Coe*.<sup>212</sup>

2. *Center Township of Marion County v. Coe*.—*Coe* was a class-action suit brought on behalf of homeless persons in Indianapolis. The suit alleged that the Marion County Trustee failed to fulfill its statutory obligation to provide shelter for homeless persons. Additionally, the plaintiffs alleged that the Trustee had attempted to fulfill its obligation in a way that violated the First Amendment to the United States Constitution and article I, sections 4 and 6 of the Indiana

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208. *Boyd*, 28 N.E.2d. at 263.

209. *Accord* K.R. v. Anderson Cmty. Sch. Corp., 887 F. Supp. 1217, 1228 (S.D. Ind. 1995) *rev'd* on other grounds, 125 F.3d 1017 (7th Cir. 1997) (holding that providing support for a disabled student attending a parochial school would not violate article I, section 6, because "the school corporation is not being asked to pay St. Mary's directly to provide religious or general educational services.").

210. 44 N.E.2d 494 (Ind. 1942).

211. *Id.* at 496. The only other treatment of this issue misidentifies the relevant test. See Jennifer L. Smith, Note, *Educational Vouchers in Indiana? – Considering the Federal and State Constitutional Issues*, 34 VAL. U. L. REV. 275 (1999). Smith argues that, for a voucher program to survive under section 6, funds would have to be given directly to students and the students could not be required to attend religious activities. *Id.* at 330. This analysis fails to consider the actual requirements of section 6; the provision is offended only by the payment of state funds, directly or indirectly, where such payments amount to a gift, subsidy, or donation to a religious entity, including, but not limited to, sectarian schools. Moreover, Smith omits any significant analysis of relevant Indiana history.

212. 572 N.E.2d 1350 (Ind. Ct. App. 1991).



Constitution.<sup>213</sup> In *Coe*, the Trustee attempted to fulfill at least part of its obligation by using religious missions as homeless shelters. These missions, however, required homeless persons to attend religious services as a condition of shelter.

In *Coe*, there was little question that the Trustee's practice violated the First Amendment. The court of appeals noted that

[t]he Trustee cannot avoid its constitutional responsibilities by contracting with private organizations to supply the relief the Trustee is obligated by statute to provide to the Appellees. The Appellees had a statutory right to shelter and the Trustee's action compelled many of them to attend religious services as a condition of exercising that right.<sup>214</sup>

It was a basic point of law, the court thought, that "a person cannot be compelled to choose between the exercise of a First Amendment right and participation in an otherwise available public program."<sup>215</sup>

With regard to the Indiana Constitution, the court thought it "patently" clear that the Trustee's practice violated article I, section 4, because it compelled persons to attend a place of worship against their consent in order to receive entitlement benefits.<sup>216</sup> The court looked to *Boyd* to determine whether the Trustee's practice violated article I, section 6. Unlike *Boyd*, where the government entity closely monitored the schools to ensure that no religious instruction took place, "the Trustee exercise[d] no control over the missions and ma[de] no effort to separate the missions' sectarian purpose from the statutory benefit to the Appellees."<sup>217</sup> In *Coe*, the court held that "the payment of public funds to religious missions which they use for religious purposes violates Article I, Section 6 of the Indiana Constitution."<sup>218</sup> The Trustee's actions violated *Boyd*'s two-part test because the funds paid were used to support religious activities that homeless persons were compelled to attend. The *Coe* court was careful to note that nothing in either the Indiana or the United States Constitution prohibited "the use of religious missions as vendors of shelter services if the missions do not condition the receipt of shelter on attendance at religious services."<sup>219</sup>

Thus, *Coe* reinforces two relevant points about sections 4 and 6. First, *Coe* makes it readily apparent that section 6 is not a narrowly drawn Blaine Amendment. If it were, it would apply only to school funding and would be immaterial to cases such as *Coe* that deal with funds provided to other religious entities. Second, as part of an Establishment Clause, section 6 works in tandem with section 4 to impose typical requirements upon the payment of public funds

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213. *Id.* at 1352.

214. *Id.* at 1360.

215. *Id.* (citing *Thomas v. Review Bd. of Ind.*, 450 U.S. 707, 716 (1981)).

216. *Id.*

217. *Id.*

218. *Id.*

219. *Id.*

to religious entities. Thus, in *Coe*, article I, sections 4 and 6 prohibited the payment of public funds to religious organizations, where those funds were actually used for religious purposes.

### *E. Constitutionality of a Model Voucher Program*

With respect to article I, sections 4 and 6 of the Indiana Constitution, the Indiana Supreme Court has developed a two-part test to assess the constitutionality of any state action that involves the payment of public funds to religious institutions. A third aspect of such an assessment is the consideration of any historical factors bearing upon the analysis. With regard to the third prong, as discussed previously,<sup>220</sup> it is not possible to ascribe the changes instituted by the 1851 Constitution to a desire to prevent the public funding of religious schools. These changes, which find expression in article I, section 6, do not, therefore, impugn a model voucher program.

Rather, the changes in the 1851 Constitution and Indiana's adoption of a common school system were, as discussed earlier,<sup>221</sup> principally a three-fold reaction to Indiana's unenviable position during the mid-nineteenth century. First, the changes were a response to the failure of Indiana's voluntary, private, local school system. Second, the changes were a reaction to Indiana's fiscal collapse and a desire to accomplish more schooling in a less-expensive fashion. Finally, the changes were part of the larger desire to do away with special and local legislation in favor of generalized legislation. A model voucher program offends none of these criteria.

The Indiana Supreme Court's jurisprudence, Indiana history, and the text of article I, sections 4 and 6 make it clear that the sections work in tandem as an Establishment Clause, designed to prevent the capture of state funds by religious groups, where those funds amount to a gift, subsidy, or donation to advance the group's religious mission. For a model voucher program to violate sections 4 and 6, the funds, made payable to the parents of children attending a religious school, would have to amount to a subsidy that supported the school's religious mission. For two related reasons, vouchers are not such a subsidy.

First, a model voucher program contains an opt-out provision, which allows children, on a parent's written request, not to attend religious activities at religious schools.<sup>222</sup> Under a model voucher program, participating students are not forced to choose religious schools nor are they forced to attend religious activities at religious schools. If students using vouchers attend religious activities, they do so only by individual, private choice.

Second, it does not violate the Indiana Constitution for public funds to flow to religious institutions, when those funds are directed to the religious institution

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220. See discussion *supra*, Part III.B.3.

221. See discussion *supra*, Part III.B.3.

222. See, e.g., *Jackson v. Benson*, 578 N.W.2d 602, 609 (Wis. 1998) (opt-out provision from religious activities in voucher program passed constitutional muster under Wisconsin law); *supra* note 14.



by private individuals and are made available under general, neutral programs. In *Jackson v. Benson*, the Wisconsin Supreme Court considered a challenge to the Milwaukee Voucher Program, under article I, section 18 of the Wisconsin Constitution,<sup>223</sup> from which the drafters of the 1851 Indiana Constitution borrowed in writing article I, section 6.<sup>224</sup> The Wisconsin Supreme Court found that

funds may be placed at the disposal of third parties so long as the program on its face is neutral between sectarian and nonsectarian alternatives and the transmission of funds is guided by the independent decision of third parties and that public funds generally may be provided to sectarian educational institutions so long as steps are taken not to subsidize religious functions.<sup>225</sup>

This view accords with the long line of U.S. Supreme Court jurisprudence.<sup>226</sup> It would be an extreme departure from generally settled law for the Indiana Supreme Court to find that where individuals direct public funds to religious institutions by their own private choices, where the funds flow from a neutral, generally applicable program, these actions violate article I, sections 4 and 6. Such a conclusion would have far-reaching consequences, drawing into the fray both state employees who choose to direct a portion of their paychecks to a religious entity,<sup>227</sup> and long-standing state scholarship and financial aid programs (GI Bill and Pell Grants) given to institutions of higher education.<sup>228</sup> Such a decision would also call into question Medicare and Medicaid programs that have long reimbursed religiously affiliated health-care providers.<sup>229</sup>

223. Article I, section 18 of the Wisconsin Constitution provides:

The right of every person to worship Almighty God according to the dictates of conscience shall never be infringed; *nor shall any person be compelled to attend, erect or support any place of worship, or to maintain any ministry, without consent*; nor shall any control of, or interference with, the rights of conscience be permitted, or any preference be given by law to any religious establishments or modes of worship; *nor shall any money be drawn from the treasury for the benefit of religious societies, or religious or theological seminaries.*

WISC. CONST. art. I, § 18 (emphasis added).

224. See JOURNAL OF THE CONVENTION OF THE PEOPLE OF THE STATE OF INDIANA TO AMEND THE CONSTITUTION 964 (1851).

225. *Jackson*, 578 N.W.2d at 621 (citations omitted).

226. See discussion in *supra* Part II.A.

227. See *Agostini v. Felton*, 521 U.S. 203, 226 (1997).

228. See *Witters v. Washington Dep't of Servs. for the Blind*, 474 U.S. 481, 486-87 (1986); *Tilton v. Richardson*, 403 U.S. 672 (1971).

229. Provisions of the Medicare and Medicaid acts, for instance, allow patients at "religious nonmedical health care institutions" (e.g., Christian Scientist sanatoria) to receive government benefits, which are, of course, paid directly to the health care institutions for treatment at these institutions. See *Children's Healthcare Is a Legal Duty, Inc. v. Min de Parle*, 212 F.3d 1084 (8th Cir.) (holding that these provisions do not violate the First Amendment's Establishment Clause),

Thus, a model voucher program does not violate article I, sections 4 and 6 of the Indiana Constitution because the built-in opt-out provision provides protection against state funds supporting religious activities. Further, because the funds are used at religious schools only as the result of individual choices, the funds are not a direct state subsidy of any sect's religious mission.

### CONCLUSION

This Article has examined the constitutionality under the Indiana Constitution of a model student voucher program. Such a program is constitutional for three reasons. First, the Indiana Supreme Court's jurisprudence, Indiana history, and the text of article I, sections 4 and 6 make it clear that these sections work in tandem, as an Establishment Clause, to prevent the capture of state funds by religious groups, where those funds amount to a gift, subsidy, or donation to advance the group's religious mission. Under a model voucher program, state funds that may reach religious groups are not a gift, subsidy, or donation. Second, because the funds are not used for religious purposes, they do not amount to a "donation to the church" and are not subsidies to promote a religious mission. Further, private choice forms a barrier between the state and the use of any funds to support an institution's religious mission. Under a model voucher program, any funds that flow to religious schools do so only because individual families and schools chose to participate in the program. Finally, a model voucher program does not offend the Indiana Constitution because it is consistent with the historical purposes behind the changes made in the 1851 Constitution. Additionally, where state funds flow to religious institutions from neutral, generally applicable programs, the First Amendment's Establishment Clause is not violated if the funds are directed by independent, private decisions of third parties. In summary, a model voucher program in Indiana will survive scrutiny under both the Indiana and United States Constitutions.

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*cert. denied*, 121 S. Ct. 1483 (2000); *see also* *Bradfield v. Roberts*, 175 U.S. 291 (1899) (approving payments of federal funds to hospital run by the Catholic Church); *Craig v. Mercy Hosp.-Street Mem'l*, 45 So. 2d 809 (Miss. 1950) (approving payments of state and federal funds to hospital run by Catholic Church under state and federal constitutions). *But see* *Bd. of County Comm'rs of Twin Falls County v. Idaho Health Facilities*, 531 P.2d 588 (Idaho 1975) (holding that the issuance of bonds, in favor of hospitals run by religious organizations, would violate state constitution).



## NOTES

### ARTIFICIAL INSEMINATION: RIGHT OF PRIVACY AND THE DIFFICULTY IN MAINTAINING DONOR ANONYMITY

LUCY R. DOLLENS\*

#### INTRODUCTION

An increase in infertility, a decline in the number of healthy infants available for adoption, and the desire to be genetically related to their own children forces many infertile couples to turn to the medical profession in order to start a family.<sup>1</sup> Sperm banks present such couples with one method by which they can conceive and raise the child they never thought possible.<sup>2</sup> Today, the use of assisted reproductive technology has greatly enhanced an infertile couple's ability to become parents.<sup>3</sup> Such technology is becoming extremely appealing as couples may hand-select certain genetic characteristics for their child from a pool of donor applicants and have sperm screened for genetic diseases and irregularities; therefore, the use of assisted reproductive technology has grown dramatically.<sup>4</sup>

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1. Hollace S. W. Swanson, *Donor Anonymity in Artificial Insemination: Is It Still Necessary?*, 27 COLUM. J.L. & SOC. PROBS. 151, 153 (1993). The number of American women of childbearing age who suffered from fertility problems jumped from 4.9 million to 6.1 million between 1988 to 1995, representing a twenty-five percent increase. Michael D. Lemonick, *The New Revolution in Making Babies: A Host of Breakthroughs—From Frozen Eggs to Borrowed DNA—Could Transform the Treatment of Infertility. But Tampering with Nature Can Be Risky*, TIME, Dec. 1, 1997, at 40.

2. According to the American Society for Reproductive Medicine, infertility affects more than six million Americans, half of whom are men. Leslie Milk, *Looking for Mr. Good Genes*, WASHINGTONIAN, May 1999, at 65. See also Keith Alan Byers, *Infertility and In Vitro Fertilization: A Growing Need for Consumer-Oriented Regulation of the In Vitro Fertilization Industry*, 18 J. LEGAL MED. 265, 266 (1997) (8.5% to twenty percent of married couples in the United States experience problems with fertility).

3. "In part, as a result of the freedom from regulation that came with constitutional protection, infertility services have been transformed from a small medical specialty to a four billion-dollar annual industry." Lori B. Andrews, *Reproductive Technology Comes of Age*, 21 WHITTIER L. REV. 375, 382 (1999).

4. See Bill Briggs, *Babies by the Book: Sperm, Egg Catalogs Just the Start*, DENVER POST, May 21, 1997, at G1 ("[p]rocur[ing] a man's spare sperm . . . can take you on a shopping trip like no

Artificial insemination is just one method of assisted reproduction<sup>5</sup> and includes homologous insemination, which involves a husband or sexual partner's sperm, and heterologous insemination, which involves artificial insemination by donor (A.I.D.).<sup>6</sup> Donor insemination costs between \$235 and \$400 before medicine and blood work and is widely practiced.<sup>7</sup> In the United States alone, 20,000 to 30,000 babies are conceived each year by A.I.D.<sup>8</sup>

The increasing use of A.I.D. as a means of conception raises a host of

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other, to a place where the aisles are stocked with personalities, hair colors and skin tones"); Warren E. Leary, *Rules to Cover Human Tissue in Products*, N.Y. TIMES, Mar. 1, 1997, at A1 (sperm banks have followed voluntary guidelines and state laws in testing for hepatitis and H.I.V.); Marilyn Chase, *Sperm Banks Thrive Amid Debate Over Medical and Ethical Issues*, WALL ST. J., Apr. 2, 1987, at 1987 WL-WSJ 319194 ("[sperm] banks offer greater selection and accessibility, as well as higher safety because frozen sperm can be easily quarantined while donors are retested for disease"). In 1995 alone, 59,142 assisted reproductive technology (A.R.T.) procedures were performed in the United States. Nat'l Ctr. for Chronic Disease Prevention and Health Promotion, *1995 Assisted Reproductive Technology Success Rates: National Summary and Fertility Clinic Reports* (1997), available at [http://www.cdc.gov/nccdphp/drh/arts/art\\_type.htm](http://www.cdc.gov/nccdphp/drh/arts/art_type.htm) (last reviewed Jan. 10, 2000). In 1996, the number of A.R.T. procedures performed increased to 64,036, resulting in the birth of over 20,000 babies. Nat'l Ctr. for Chronic Disease Prevention and Health Promotion, *1996 Assisted Reproductive Technology Success Rates: National Summary and Fertility Clinic Report*, available at [http://www.cdc.gov/nccdphp/dr/art96/sec1\\_q1.htm](http://www.cdc.gov/nccdphp/dr/art96/sec1_q1.htm) (last reviewed Jan. 10, 2000) (discussing other forms of reproductive technology). In 1997, approximately 71,826 A.R.T. procedures were performed, resulting in 17,054 deliveries of one or more living infants and 24,582 babies. Nat'l Ctr. for Chronic Disease Prevention and Health Promotion, *1997 Assisted Reproductive Technology Success Rates: National Summary and Fertility Clinic Report* (last reviewed Jan. 13, 2000) [hereinafter C.D.C. 1997 Nat'l Report]. See also Fred Norton, *Assisted Reproduction and the Frustration of Genetic Affinity: Interest, Injury, and Damages*, 74 N.Y.U. L. REV. 793, 793-94 (1999).

5. Artificial insemination can be accomplished by using frozen spermatozoa, which results in a sixty percent successful pregnancy rate, or by using freshly collected semen, which is successful ninety percent of the time. Microsoft Encarta Online Encyclopedia 2000, Microsoft Corporation, "Artificial Insemination" (1997-2000), available at <http://encarta.msn.com/find/Concise.asp?ti=05FB4000>. Artificial insemination is typically recommended for the treatment of male factor infertility and "unexplained" infertility. Anna Peris, *Therapies: Artificial Insemination*, available at [http://www.fertilitext.org/p2\\_doctor/AI.html](http://www.fertilitext.org/p2_doctor/AI.html) (last visited Oct. 22, 2001).

6. Miller-Keane Medical Dictionary, "Artificial Insemination," (2000), available at [http://content.health.msn.com/content/asset/miller\\_keane\\_17380](http://content.health.msn.com/content/asset/miller_keane_17380) (last visited Oct. 22, 2001).

7. See Milk, *supra* note 2, at 65. Recently, artificial insemination was cast into the public eye with an announcement by Melissa Etheridge and Julie Cypher that David Crosby was the father of their two children conceived by artificial insemination. Julie Rawe, *People*, TIME, Oct. 2, 2000, at 109. Many other individuals, including a priest in one reported incident, utilize artificial insemination. Marjorie Hyer, *A Need Examined, a Prayer Fulfilled; Unmarried Priest Bears Child by Artificial Insemination*, WASH. POST, Dec. 7, 1987, at A1.

8. Marsha Garrison, *Law Making for Baby Making: An Interpretive Approach to the Determination of Legal Parentage*, 113 HARV. L. REV. 835, 845 (2000).



important legal questions of first impression. Scholars, courts, and state legislatures have already begun to address the effect of A.I.D. on the "traditional" family structure, the legal determination of parental rights in A.I.D., and the moral implications of A.I.D.<sup>9</sup> Yet, with the widespread access to sperm banks and fertility clinics, these reproductive technology centers continue to be the center of legal disputes.<sup>10</sup>

One such legal dispute involved Dr. Cecil Jacobson, a Virginia physician, who violated his agreements with patients to provide sperm from anonymous donors when he repeatedly artificially inseminated women with his own sperm for over ten years, resulting in the births of over seventy-five children.<sup>11</sup> In another dispute in Naples, Italy, Dr. Raffaele Magli was indicted for allegedly using sperm from only two donors to impregnate all of his patients, creating thousands of half-brothers and half-sisters among his patients.<sup>12</sup> Additionally, many women have claimed that fertility clinics negligently caused them to be impregnated with the sperm of men who were not their chosen donors.<sup>13</sup> More

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9. See generally Carlos A. Ball & Janice Farrell Pea, *Warring with Wardle: Morality, Social Science, and Gay and Lesbian Parents*, 1998 U. ILL. L. REV. 253; R. Alta Charo, *And Baby Makes Three—Or Four, or Five, or Six: Redefining the Family After the Reprotech Revolution*, 15 WIS. WOMEN'S L.J. 231 (2000); Garrison, *supra* note 8, at 835; John Lawrence Hill, *What Does It Mean to Be a "Parent"? The Claims of Biology as the Basis for Parental Rights*, 66 N.Y.U. L. REV. 353, 413-20 (1991).

10. Over 335 fertility clinics are in operation in the United States. C.D.C., 1997 Nat'l Report, *supra* note 4; see also Lemonick, *supra* note 1, at 40 (there are hundreds of fertility clinics around the world); Ian Fisher, *4 Charged in Illegal Sperm Bank*, N.Y. TIMES, Apr. 27, 1992, at B5 (Mount Sinai Medical Center employees charged with seventeen counts stemming from illegal sale of their semen to doctors, who then inseminated a dozen women).

11. Milk, *supra* note 2, at 65 (Dr. Jacobson was convicted on fifty-two counts of fraud and perjury). See also Byers, *supra* note 2, at 307-08; Norton, *supra* note 4, at 795.

12. Sandra Anderson Garcia, *Sociocultural and Legal Implications of Creating and Sustaining Life Through Biomedical Technology*, 17 J. LEGAL MED. 469, 494 (1996); Frances D'Emilio, *Gynecologist Accused of Abuse in "Test-Tube" Birth*, ASSOCIATED PRESS, Apr. 5, 1995, available at 1995 WL 4381894.

13. Norton, *supra* note 4, at 795-96. See, e.g., Harnicher v. Univ. of Utah Med. Ctr., 962 P.2d 67, 68 (Utah 1998) (noting that one of triplet infants had different coloring than mother's husband and was found to have been fathered by wrong sperm donor); Ann Davis, *High-Tech Births Spawn Legal Riddles*, WALL ST. J., Jan. 26, 1998, at B1 (describing lawsuit alleging that hospital used wrong sperm, resulting in interracial couple having white children); Dorinda Elliot & Friso Endt, *Twins—with Two Fathers*, NEWSWEEK, July 3, 1995, at 38 (one infant from set of twins conceived by assisted reproductive technology was discovered to have been result of another man's sperm wrongly used); *New Jersey Couple Sue Over an Embryo Mix-Up at Doctor's Office*, N.Y. TIMES, Mar. 28, 1999, at 45 (New Jersey couple sued a fertility clinic after several of their embryos accidentally were implanted in another of clinic's patients); *Sperm Mix-Up Lawsuit Is Settled*, N.Y. TIMES, Aug. 1, 1991, at B4 (describing a case in which a mother sued sperm bank Idant Labs, claiming they mistakenly substituted another man's sperm for her late husband's, which ultimately settled for \$400,000); Mike Stobbe, *Alleged Mix-up Leads to Lawsuit*, FLA. TIMES-

recently, a couple claimed that a sperm bank falsely conveyed to them that the anonymous donor's sperm was thoroughly screened and free of genetic disease.<sup>14</sup> Subsequently, however, the conceived child developed Autosomal Dominant Polycystic Kidney Disease. Clearly, the conduct involved in these disputes represent legal issues which require the attention of and resolution by the courts.

However, with little precedence to follow, states have only just begun to develop law surrounding A.I.D.<sup>15</sup> Most states have enacted statutes allowing the use of artificial insemination with donor sperm, and thirteen of those statutes are modeled on the Uniform Parentage Act, which defines the parental rights of the parties involved.<sup>16</sup> Several states have specifically addressed the inheritance rights of children conceived by A.I.D.,<sup>17</sup> and some states have created legal obligations for testing sperm donations for H.I.V. prior to use.<sup>18</sup>

However, few authorities or court decisions address a sperm donor's right to remain anonymous in the course of an A.I.D. procedure and in the resulting child's life. At least eighteen states have enacted legislation permitting A.I.D. children to obtain sperm donor information based on a satisfactory showing of good cause or a similar standard.<sup>19</sup> In these states, courts must weigh the

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UNION, Sept. 1, 1997, at A5 (DNA tests revealed that twins conceived were not biologically related to the mother's husband, revealing that another man's sperm had been wrongly used); Ronald Sullivan, *Mother Accuses Sperm Bank of a Mixup*, N.Y. TIMES, Mar. 9, 1990, at B2; Tracy Weber, *Suit Claimed Wrong Sperm Used at Saddleback Center*, L.A. TIMES, June 9, 1995, at A34 (mother inseminated with sperm of an unknown man, instead of with husband's donated sperm).

14. See *Johnson v. Superior Court*, 95 Cal. Rptr. 2d 864 (Ct. App. 2000), *review denied*, Aug. 23, 2000.

15. Laws governing the use of artificial insemination are largely nonexistent. See Garrison, *supra* note 8, at 838.

16. The Uniform Parentage Act provides that

[i]f, under the supervision of a licensed physician and with the consent of her husband, a wife is inseminated artificially with sperm donated by a man not her husband, the husband is treated in law as if he were the natural father of a child thereby conceived. . . . [and] the donor of semen provided to a licensed physician for use in artificial insemination of a married woman other than the donor's wife is treated in law as if he were not the natural father of a child thereby conceived.

UNIF. PARENTAGE ACT § 5(a)-(b), 9B U.L.A. 287, 301-02 (1994); Radhika Rao, *Reconceiving Privacy: Relationships and Reproductive Technology*, 45 UCLA L. REV. 1077, 1120 n.237 (1998) (states that have modeled their legislation after the UPA include Alabama, California, Colorado, Illinois, Minnesota, Missouri, Montana, Nevada, New Jersey, New Mexico, Washington, Wisconsin, and Wyoming).

17. Megan D. McIntyre, Comment, *The Potential for Products Liability Actions When Artificial Insemination by an Anonymous Donor Produces Children with Genetic Defects*, 98 DICK. L. REV. 519, 519-20 n.5 (1993) (Arkansas, Connecticut, Michigan, North Dakota, and Virginia).

18. *Id.* at 520 n.6 (Delaware, Georgia, Idaho, Indiana, Maryland, Montana, North Carolina, Ohio, Oklahoma, Rhode Island, and Wisconsin).

19. See Garrison, *supra* note 8, at 898-99; see also ALA. CODE § 26-17-21(a) (2001); CAL. FAM. CODE § 7613(a) (West 2001); COLO. REV. STAT. ANN. § 19-4-106(1) (West 2001); MO. ANN.



interests of the parties involved to determine what constitutes the good cause necessary to warrant disclosure. In a recent decision, *Johnson v. Superior Court*, the California Court of Appeals found that a sperm donor's constitutional right of privacy in maintaining anonymity was limited and, therefore, was outweighed by the state's interest in preserving a litigant's discovery rights in anticipation of litigation.<sup>20</sup> The effect of this decision is likely to be far reaching, greatly impacting the relatively new legal developments regarding assisted reproduction.

Part I of this Note examines the historical development of a right of privacy. It addresses the boundaries of the constitutional right to procreate and queries whether this fundamental right includes the right to reproduce with the aid of A.I.D. Part I outlines three theories that support the proposition that the right to procreate includes the right to use reproductive technology, as well as discusses the guarantees included within the right to procreate via A.I.D.

Part II explains the right of privacy in the context of discovery proceedings and discusses *Johnson*, the first case to address whether a sperm donor has the right to remain anonymous.<sup>21</sup> It examines the California Court of Appeals' rationale and final holding in which the court determined that a donor possesses merely a limited right of privacy<sup>22</sup> and that the state was justified in infringing upon the sperm donor's privacy interest.<sup>23</sup>

Finally, Part III of this Note addresses the potential impact of the *Johnson* ruling on the law of A.I.D. This Part examines the effects of the court's finding both that a sperm donor has a limited right to privacy and that promising anonymity in sperm donation contracts is contrary to public policy.<sup>24</sup> This Part also posits that such a decision jeopardizes a couple's right to procreate with A.I.D. Although A.I.D. participants may think that easier access to donor information and identity is beneficial, it may conversely be more harmful to the parties involved. It subjects the A.I.D. participant family to intrusion by the sperm donor and the state, thus infringing on the couple's right to rear a child independently, as guaranteed by the right of privacy.

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STAT. § 210.824.1 (West 2001); MONT. CODE ANN. § 40-6-106(1) (2000); NEV. REV. STAT. ANN. § 126.061.1 (2001); N.M. STAT. ANN. § 40-11-6-(C) (Michie 2000); WIS. STAT. ANN. § 891.40(1) (West 2001); WYO. STAT. ANN. § 14-2-103(a) (Michie 2000).

20. 95 Cal. Rptr. 2d 864, 864 (Ct. App. 2000), *review denied*, Aug. 23, 2000. *See also* Associated Press, *Court Upholds Limit on Sperm Donors' Privacy*, L.A. TIMES, Aug. 25, 2000, at A15; Julie Brienza, *Sperm Donor Must Testify About Medical History*, TRIAL, Aug. 2000, at 82; Kevin Livingston, *Judge: Sperm Bank's Guarantee of Anonymity Is Not Ironclad*, RECORDER (San Francisco), May 23, 2000, at 4. The issue of sperm donor anonymity is faced world-wide. *See* John Carvel, *Sperm Donors Face Loss of Privacy*, GUARDIAN (U.K.), Dec. 27, 2000, *available at* 2000 WL 30814915 ("[England's] government is about to relax strict rules of confidentiality protecting the identity of sperm donors to allow their children to discover key facts about their genetic origins.").

21. *See Johnson*, 95 Cal. Rptr. 2d at 864.

22. *Id.* at 876.

23. *Id.* at 878.

24. *Id.* at 874-75 (finding such contracts unenforceable).

Part III also delves into the *Johnson* court's apparent presumption that sperm donors choose to donate merely for the financial gain, discounting the possibility that a desire to perpetuate a genetic likeness may instead be a donor's motivation.<sup>25</sup> This Part also speculates regarding *Johnson*'s potential impact on the hypothetical situation in which a donor attempts to ascertain the identity and related information of the A.I.D. conceived child, the result of which might result in an infringement upon the child's privacy rights. This Part also examines the possibility that finding a limited right of privacy for donors creates a reluctance in men to donate. Finally, Part III highlights the fact that the *Johnson* decision improves the standards of genetic screening by providing participants of A.I.D. with the means necessary to successfully bring suit against sperm banks and hold them accountable for misrepresentations.

The *Johnson* decision went too far in limiting a sperm donor's right to remain anonymous; however, decisions like *Johnson* are necessary to develop and clarify the law concerning A.I.D. As courts begin addressing the issues of donor anonymity, individuals will be able to make more informed decisions about whether to donate sperm and families will be able to make more informed decisions about whether to conceive a child using this rapidly increasing reproductive technology.

## I. HISTORICAL DEVELOPMENT OF THE RIGHT OF PRIVACY

### A. *The Zone of Privacy Encompasses the Right to Procreate*

*Griswold v. Connecticut* gave explicit recognition to the constitutional right of privacy.<sup>26</sup> Justice Douglas, delivering the opinion of the Court, found that the right of privacy existed in the penumbras of the Bill of Rights<sup>27</sup> and determined that this right was grounded in the Due Process Clause of the Fourteenth Amendment and its concept of personal liberties and restrictions on the states.<sup>28</sup> In subsequent decisions, the Court articulated that the right of privacy protects personal rights that are deemed fundamental or implicit in our nation's concept of ordered liberty.<sup>29</sup> Found within this zone of privacy is the fundamental right

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25. *Id.* at 877.

26. 381 U.S. 479 (1965).

27. *Id.* at 483. See also *Poe v. Ullman*, 367 U.S. 497, 516-22 (1961) (Douglas, J., dissenting). These penumbras, which are unnamed rights, grow out of the specific fundamental guarantees granted in the Bill of Rights and create a constitutionally protected zone of privacy. The Court listed examples of specific guarantees in the Bill of Rights that create the zone of privacy, including the First Amendment's right of association, the Third Amendment's prohibition against quartering soldiers in any house without the owner's consent, the Fourth Amendment's right to be free from unreasonable search and seizure, and the Fifth Amendment's right to be free from self-incrimination. See *Griswold*, 381 U.S. at 484.

28. See *Roe v. Wade*, 410 U.S. 113, 153 (1973) (lower court alternatively found right of privacy to reside within Ninth Amendment's reservation of rights to the people).

29. *Id.* at 152.



to procreate.<sup>30</sup>

In *Griswold*, the Court found that the statute at issue, which prohibited the use of contraceptives, infringed upon a married couple's zone of privacy and was, therefore, invalid.<sup>31</sup> Subsequently in *Eisenstadt v. Baird*, the Court extended the zone of privacy to protect not only decisions by married couples about whether to bear a child, but also to protect an individual's decision whether to beget a child.<sup>32</sup> The court held that "[i]f the right to privacy means anything, it is the right of the individual, married or single, to be free from unwarranted government intrusion into matters so fundamentally affecting a person as the decision whether or not to bear or beget a child."<sup>33</sup>

Thereafter, in the landmark case *Roe v. Wade*, the Court held that the right of privacy "is broad enough to encompass a woman's decision whether or not to terminate her pregnancy."<sup>34</sup> The Court established an unrestricted right for a woman to choose whether or not to terminate her pregnancy in the first trimester.<sup>35</sup> Subsequently, in *Planned Parenthood of Southeastern Pennsylvania v. Casey*, the Court reaffirmed *Roe*, again finding that the right to terminate a pregnancy belonged to an individual, as guaranteed by the right of privacy.<sup>36</sup> The Court found that "when the State restricts a woman's right to terminate her pregnancy, it deprives a woman of the right to make her own decision about reproduction and family planning—critical life choices that this Court long has deemed central to the right to privacy."<sup>37</sup> Thus, a woman now has the fundamental right to terminate her pregnancy while the fetus is in the pre-viability stage.<sup>38</sup>

In additional cases, the Court continued to emphasize the importance of the right to procreate, its existence as a fundamental right, and its protection by the right of privacy. In *Stanley v. Illinois*, the Court emphasized that "[t]he rights to conceive and to raise one's children have been deemed essential, basic civil

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30. See *Skinner v. Oklahoma*, 316 U.S. 535, 541 (1942) ("[m]arriage and procreation are fundamental to the very existence and survival of the race").

31. 381 U.S. at 485.

32. 405 U.S. 438, 453 (1972) (Court struck down statute forbidding distribution of contraceptives to unmarried persons on Equal Protection grounds).

33. *Id.*

34. 410 U.S. at 153.

35. *Id.* at 163 (state's *legitimate* interest in the health of the mother becomes compelling only at end of the first trimester because until then, mortality in abortion may be less than mortality in normal childbirth).

36. 505 U.S. 833, 927 (1992).

37. *Id.* In *Casey*, however, the Court rejected the trimester framework of *Roe*, replacing it with a viability standard. See *id.* at 877.

38. See *id.*; *infra* note 44 and accompanying text. In addition to contraception, procreation, and marital relations, the right of privacy also extends to protect the right to marry a person of one's own choosing and the liberty to direct the raising of one's own children. See *Zablocki v. Redhail*, 434 U.S. 374 (1978) (marriage); *Loving v. Virginia*, 388 U.S. 1 (1967) (marriage); *Pierce v. Soc'y of Sisters of the Holy Names of Jesus & Mary*, 268 U.S. 510 (1925) (childrearing).

rights of man, and rights far more precious . . . than property rights.”<sup>39</sup> The Court indicated “[i]t is cardinal with us that the custody, care, and nurture of the child reside first in the parents, whose primary function and freedom include preparation for obligations the state can neither supply nor hinder.”<sup>40</sup> In *Carey v. Population Services International*, the Court held that “the Constitution protects individual decisions in matters of childbearing from unjust intrusion by the State,” again stressing the importance of personal freedom to make decisions in matters of procreation.<sup>41</sup>

The constitutional right of privacy, however, is not absolute.<sup>42</sup> It exists only in the absence of a compelling state interest to the contrary. Therefore, the government may not infringe upon the fundamental right of privacy interest *unless* the infringement is narrowly tailored to serve a compelling state interest.<sup>43</sup> For example, the state’s interest in protecting a mother’s health or the potential life of a fetus is compelling enough to justify state regulation of abortion at the pre-viability stage of pregnancy, provided that such regulation does not place an undue burden on the mother’s right to choose abortion.<sup>44</sup>

Furthermore, the right to procreate may be viewed as a negative right in that it exists as an individual’s right to be *left alone* in making decisions surrounding whether to reproduce.<sup>45</sup> However, it is not clear whether this negative right to reproduce extends to an entitlement to reproduce in any possible way. Therefore, the right to gain access to a sperm clinic and the entitlement to use assisted reproductive technologies present important issues in the rising use of assisted reproduction.

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39. 405 U.S. 645, 651 (1972) (the Court struck down a statute that automatically deprived unwed fathers of custody of their children upon their mothers’ deaths) (citations and internal quotation marks omitted).

40. *Id.* (quoting *Prince v. Massachusetts*, 321 U.S. 158, 166 (1944)).

41. 431 U.S. 678, 687 (1977).

42. *See id.* at 686; *Roe v. Wade*, 410 U.S. 113, 155 (1973); *Stanley*, 405 U.S. at 656.

43. *See Washington v. Glucksberg*, 521 U.S. 702, 721 (1997); *Reno v. Flores*, 507 U.S. 292, 302 (1993); *United States v. Carolene Products Co.*, 304 U.S. 144, 153 n.4 (1938).

44. *See Casey*, 505 U.S. at 878 (an undue burden exists if purpose or effect of a law “is to place a substantial obstacle in the path of a woman seeking abortion before the fetus attains viability”).

45. *See Katz v. United States*, 389 U.S. 347 (1967) (“a person’s general right to privacy—his right to be let alone by other people”) (emphasis omitted); *Scouting the Frontiers of the Law: Lawyres [sic] and Judges Are Venturing into Uncharted Territories Where Medicine and the Law Intersect. Bioethics Can Be Their Guide*, TRIAL, Sept., 1999, at 24 [hereinafter *Scouting the Frontiers of the Law*]; Rao, *supra* note 16, at 1079 (“privacy is the quintessential negative right—a right to be free from governmental interference”); Jed Rubenfeld, *The Right of Privacy*, 102 HARV. L. REV. 737, 784 (1989) (the right of privacy is not freedom to perform affirmative acts, but rather freedom from having one’s life completely determined by the state).



*B. The Constitutional Right to Procreate Using A.I.D.*

Courts have only seldom addressed the constitutionality of state restrictions on assisted reproductive technologies.<sup>46</sup> The few cases that confront the issue of whether a married couple possesses the right to procreate by means of artificial insemination involve prison inmates.<sup>47</sup> These decisions uniformly find that inmates (whether married or single) do not possess the right to reproduce by means of artificial insemination using even their own sperm.<sup>48</sup> These decisions, however, are confined to the penal context and therefore leave unclear whether there is a right to procreate via artificial insemination outside of prison.

Many scholars posit that the Constitution protects the right to reproduce with the aid of technology.<sup>49</sup> There are three theories that support the proposition that the constitutional right to procreate includes the right to reproduce with the aid of A.I.D. First, existing paternity, custody, visitation and artificial insemination statutes and case law imply the existence of a such a constitutional right. Second, scholars argue that intimate association guarantees this constitutional right. Finally, right of privacy cases support such a constitutional right.

*1. Existing Paternity, Custody, Visitation, and Artificial Insemination Statutes and Case Law Imply the Existence of a Constitutional Right to Procreate Using A.I.D.*—A.I.D. cases and certain statutes that involve custody and visitation rights of the resulting child “imply that there may be a right to use artificial insemination to conceive a child, even if there is no corollary right exclusively to parent the resulting child.”<sup>50</sup> Many states have adopted statutes modeled after the Uniform Parentage Act, which provides that when a married woman is impregnated by a donor’s sperm under the supervision of a licensed physician and with the consent of her husband, the husband is legally declared the natural father of the child.<sup>51</sup> These statutes sever the donor’s paternity rights only when the woman is married and inseminated by a physician. A married woman who is artificially inseminated with a donor’s sperm without her husband’s knowledge or consent lacks the right to have her husband declared the legal father of the child.<sup>52</sup>

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46. Rao, *supra* note 16, at 1081.

47. *Id.* at 1081-82 (summarizing existing case law pertaining to prisoners and denial of their right to procreate by means of artificial insemination).

48. *Id.* at 1082.

49. *See id.* at 1081 & n.10 (referring to JOHN A. ROBERTSON, CHILDREN OF CHOICE: FREEDOM AND THE NEW REPRODUCTIVE TECHNOLOGIES 38-39 (1994), which argues that procreative liberty encompasses right to use a wide variety of reproductive technologies and every practice necessary to procreate should receive constitutional protection).

50. *Id.* at 1082.

51. *Id.* at 1120 n.237 (Alabama, California, Colorado, Illinois, Minnesota, Missouri, Montana, Nevada, New Jersey, New Mexico, Washington, Wisconsin, and Wyoming).

52. *See id.*; *see also In re the Marriage of Witbeck-Wildhagen*, 667 N.E.2d 122, 126 (Ill. App. Ct. 1996) (court declined to declare husband the legal father because doing so would violate husband’s right not to procreate); *cf. R.S v. R.S.*, 670 P.2d. 923, 928 (OR 1983) (holding that

However, seven states sever a donor's rights with regard to paternity and other responsibilities if the procedure is performed under a doctor's supervision or through a sperm bank, even when the woman is single.<sup>53</sup> Thus, in these jurisdictions, the instances in which a woman may be subject to a paternity action in which the court may legally declare the semen donor to be the father are limited to those where she was impregnated artificially without the aid of a licensed physician.

In *Jhordan v. Mary K.*, the court specifically addressed the constitutionality of statutes modeled after the Uniform Parentage Act and their infringement on a woman's right of procreative choice.<sup>54</sup> In *Jhordan*, the statute at issue provided that where a physician performs artificial insemination, the sperm donor is barred from asserting parental rights.<sup>55</sup> However, the court found the statute to be inapplicable because the woman impregnated herself at home without the aid of a physician and, therefore, granted declaration of paternity and visitation rights to the sperm donor.<sup>56</sup> The woman argued that limiting the applicability of the statute to situations in which a licensed physician performed the procedure violated her fundamental right of procreative choice.<sup>57</sup> The court rejected this argument and found that such a statute did not forbid self-insemination, impose restrictions on a woman's right to bear a child, or preclude personal selection of a donor.<sup>58</sup> Rather, the statute merely spoke to the legal status of the donor's paternity. The *Jhordan* court's findings imply that a statute which does, in fact, forbid self-insemination, impose restrictions on a woman's right to bear a child, or preclude personal selection of a donor, may violate a woman's right to procreate. Thus, the state is prohibited from imposing the restrictions noted by the *Jhordan* court because the effect would be to restrict an individual's right to bear children. Moreover, in order to impose such restrictions, the state must provide a compelling state interest and narrowly tailor the statute. In this context, the fundamental right to procreate, which is constitutionally protected by the right of privacy, includes the right to use A.I.D.

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husband who orally consents that his wife be artificially inseminated with donor sperm for the purpose of producing a child of their own is estopped from denying that he is the father of that child); *In re Baby Doe*, 353 S.E.2d 877, 879 (S.C. 1987) (holding that "husband's knowledge of and assistance in his wife's efforts to conceive through artificial insemination constitute his consent to the procedure," rendering him the legal father). *But see* *K.S. v. G.S.*, 440 A.2d 64 (N.J. Super. Ct. Ch. Div. 1981) (once given, consent may be revoked before pregnancy occurs provided there is clear and convincing evidence of revocation).

53. See John E. Durkin, Comment, *Reproductive Technology and the New Family: Recognizing the Other Mother*, 10 J. CONTEMP. H. L. & POL'Y 327, 338 nn.83-84 (1994) (California, Colorado, New Jersey, Washington, Wyoming, Oregon, and Texas).

54. 224 Cal. Rptr. 530, 531 (Ct. App. 1986).

55. *Id.* (citing CAL. CIV. CODE § 7005(b) (West 1975)).

56. See 224 Cal. Rptr. at 537-38.

57. *Id.* at 536-37.

58. *Id.* at 537.



2. *Intimate Association Guarantees the Constitutional Right to Procreate Using A.I.D.*—The second theory from which support can be found that the constitutional right of privacy encompasses the right to procreate by means of A.I.D. focuses on the couple's act of intimate association. Under this approach, individuals who become involved in close, intimate relationships possess privacy rights against the state.<sup>59</sup> Privacy, in this context, is the negative right to be free from interference from the government in these intimate associations.<sup>60</sup> Therefore, when procreation with the aid of A.I.D. occurs within the confines of a close and personal association, it is afforded constitutional protection by the right of privacy.

The theory of associational right of privacy is supported by precedent. Many cases support the proposition that the constitutional right of privacy creates immunity from governmental interference when individuals are in an intimate and consensual relationship.<sup>61</sup> Furthermore, cases indicating that the right of privacy does not protect unrelated and distant individuals imply that intimate and close associations are necessary for the right of privacy to attach.<sup>62</sup>

Under the intimate association theory, the right of privacy extends to protect not only marital and biological relationships, but nontraditional associations as well.<sup>63</sup> Because the right of privacy protects procreation when it occurs within the confines of a close and personal association, then if a husband and wife, or alternatively an unmarried but intimately involved couple, chose to procreate

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59. Rao, *supra* note 16, at 1079 (discussing theory of relational right of privacy).

60. *Id.* at 1078.

61. *Id.* at 1078, 1097-98. See, e.g. Moore v. City of East Cleveland, 431 U.S. 494, 499 (1977) (quotation omitted) (zoning ordinance precluding grandmother from living with her two grandsons was deemed unconstitutional because "cases . . . have consistently acknowledged a 'private realm of family life which the state cannot enter'"); Wisconsin v. Yoder, 406 U.S. 205, 234 (1972) (relying in part on right of privacy, Court ruled that state could not require Amish parents to send their children to public school beyond eighth grade); Griswold v. Connecticut, 381 U.S. 479 (1965) (Court ruled that prohibiting use of contraceptives infringed upon a married couple's zone of privacy); *supra* note 32 and accompanying text; Poe v. Ullman, 367 U.S. 497, 539, 552 (1961) (Harlan, J., dissenting) (the Court dismissed a challenge to a Connecticut law criminalizing use of contraceptives for lack of justiciability because law had not been enforced; however, Justice Harlan determined the law to be an intolerable unjustified invasion in area of most intimate concerns of a married couple, finding that nothing could be more intimate than a husband and wife's marital relations). But cf. Bowers v. Hardwick, 478 U.S. 186, 190 (1986) (Court upheld a Georgia statute criminalizing homosexual sodomy, denying constitutional protection of right of privacy because "[n]o connection between family, marriage, or procreation on the one hand and homosexual activity on the other has been demonstrated . . .").

62. See Rao, *supra* note 16, at 1097-98; see also Roberts v. United States Jaycees, 468 U.S. 609, 618-619 (1984) (Court ruled that members of a same-sex club were not protected by the right of privacy from state anti-discrimination laws, finding that intimate associations merit protection because they create a buffer between individual and the state); Village of Belle Terre v. Boraas, 416 U.S. 1 (1974) (college roommates' living arrangements are not protected by the right of privacy).

63. Rao, *supra* note 16, at 1105.

with the aid of A.I.D., that choice must be afforded protection by the right of privacy.

Despite the fact that A.I.D. generally occurs in the presence of a third-party physician, the act of procreation does not lose its status as an act of an intimate association.<sup>64</sup> In *Paris Adult Theatre I v. Slaton*, the U.S. Supreme Court held that "the constitutionally protected privacy of family, marriage, motherhood, procreation, and child rearing is not just concerned with a particular place, but with a protected intimate relationship. Such protected privacy extends to the doctor's office; . . . or as otherwise required to safeguard the right to intimacy involved."<sup>65</sup> Thus, the right of privacy protects A.I.D. when a married or intimately associated couple uses reproductive assistance because it is performed within the context of an intimate relationship.

3. *Right of Privacy Cases Support the Constitutional Right to Procreate Using A.I.D.*—Finally, existing constitutional right of privacy cases support the constitutional right to procreate with the aid of A.I.D. Such cases support the proposition that an individual's decisions regarding procreation are protected from state intrusion. As A.I.D. is a form of procreation, it logically follows that the right of privacy must also encompass the fundamental right for a person to choose to conceive a child with the aid of such reproductive technology.<sup>66</sup> Furthermore, constitutional right of privacy cases establish that the right of privacy protects family autonomy from state intrusion in matters of conception and childrearing.<sup>67</sup> Therefore, using A.I.D. in order to create a family elevates this method of procreation to a constitutionally protected level.

First, the Supreme Court's decision in *Skinner*<sup>68</sup> supports the proposition that an individual possesses the right to procreate outside marriage by focusing on the importance of procreation both to an individual and to society as a whole.<sup>69</sup> The Court found the challenged statute, which allowed sterilization of convicted felons, to be unconstitutional because it deprived them "of a right which is basic to the perpetuation of a race—the right to have offspring."<sup>70</sup> The Court, however, did not indicate that procreation is *only* protected when traditional methods of

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64. See *id.* at 1105 n.5 (citing Kenneth L. Karst, *The Freedom of Intimate Association*, 89 YALE L.J. 624, 626 n.8 (1980), who finds that "a concern to protect the freedom [of intimate association] lies behind many of the Supreme Court's . . . decisions in the areas of marriage, procreation, and parent-child relations").

65. 413 U.S. 49, 67 (1973).

66. See Durkin, *supra* note 53, at 340-41; see also Michelle L. Brenwald & Kay Redeker, *A Primer on Posthumous Conception and Related Issues of Assisted Reproduction*, 38 WASHBURN L.J. 599, 653 (1999) (there are no limitations placed upon the process of conceiving a child naturally, therefore, assisted reproduction should be analogous).

67. Patricia A. Kern & Kathleen M. Ridolfi, *The Fourteenth Amendment's Protection of a Woman's Right To Be a Single Parent Through Artificial Insemination by Donor*, 7 WOMEN'S RTS. L. REP. 251, 260 (1982).

68. 316 U.S. 535, 536, 541 (1942).

69. See Durkin, *supra* note 53, at 340.

70. *Skinner*, 316 U.S. at 536.



conception are used. Therefore, pursuant to the boundaries of *Skinner*, because A.I.D. does represent a form of conception,<sup>71</sup> the right of privacy must protect procreation accomplished with the aid of this assisted reproduction technology.

Furthermore, the ruling in *Eisenstadt*<sup>72</sup> supports the proposition that an individual's right to make decisions about procreation derives from the individual's interest in autonomy, "regardless of the person's marital status."<sup>73</sup> The concept of individual autonomy directs that a person should be allowed to control her own body as she pleases, as long as she does not bring harm to others. In addition, *Roe* supports the proposition that a woman has the fundamental right to terminate her pregnancy.<sup>74</sup> From this trio of cases, it is clear that a person has the fundamental right to prevent pregnancy with the use of contraceptives, to terminate pregnancy by abortion, and to ultimately make decisions in matters of conception. These rights indicate that an individual has the fundamental right to control one's own reproductive system. Included within this right to control one's own reproductive system is the right to conceive with the aid of reproductive technology, including A.I.D.

Furthermore, the Court's decisions establish that the right of privacy protects family autonomy from state intrusion in matters of conception and childrearing.<sup>75</sup> The right to procreate is concerned with "the reproductive rights of the prospective *rearing* parents."<sup>76</sup> Thus, the objective of rearing a child and establishing a family elevates the right to procreate to a constitutionally protected fundamental right.<sup>77</sup> Just as a couple using the traditional means of conception does so out of a desire to rear a child and establish a family, so too does a couple that seeks A.I.D.

The right of privacy prevents a state from intruding unnecessarily upon the private relationship and concerns of a couple and, therefore, their right to procreate via assisted reproduction.<sup>78</sup> Women must "be able to choose among . . . the various reproductive alternatives . . . [for] [p]rotecting women's constitutional rights to privacy and procreation is the highest priority."<sup>79</sup> Therefore, a state must present a compelling interest to justify placing restrictions

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71. "[T]here is nothing artificial about inseminating a woman, [therefore] artificial insemination aptly describes a process that is merely an alternative to insemination through sexual intercourse." Nancy D. Polikoff, *This Child Does Have Two Mothers: Redefining Parenthood to Meet the Needs of Children in Lesbian-Mother and Other Nontraditional Families*, 78 GEO. L.J. 459, 467 n.24 (1990).

72. 405 U.S. 438, 453 (1972).

73. Durkin, *supra* note 53, at 341.

74. 410 U.S. 113, 153 (1973).

75. See generally Kern & Ridolfi, *supra* note 67.

76. Elizabeth S. Scott, *Sterilization of Mentally Retarded Persons: Reproductive Rights and Family Privacy*, 1986 DUKE L.J. 806, 829.

77. See *id.*

78. See Kern & Ridolfi, *supra* note 67, at 260.

79. Christine L. Kerian, *Surrogacy: A Last Resort Alternative for Infertile Women or a Commodification of Women's Bodies and Children?*, 12 WIS. WOMEN'S L.J. 113, 158 (1997).

on an individual's access to new reproductive technologies, including A.I.D.<sup>80</sup> A complete state ban on access to reproductive technologies would deprive an infertile couple of its only chance to procreate.<sup>81</sup>

*C. Limits on the Guarantees of the Right to Procreate Using A.I.D.*

Assuming the right of privacy protects conception that takes place with the assistance of donated sperm under one of the aforementioned theories, this right does not also include the right to use gametes from unwilling individuals, nor the right to maintain an exclusive relationship with the resulting child.<sup>82</sup> Furthermore, the right of privacy may not encompass the right to *buy* or *sell* sperm or other gametes, even if they are necessary for procreation within the context of an intimate association.<sup>83</sup> In this context, procreational services become commodities, merely goods and services, and may be regulated or proscribed altogether by states. Moreover, by bringing a third-party stranger into the intimate procreative relationship, the couple diminishes "the privacy of their association and simultaneously enhanc[es] the state's interest in protecting these other individuals, who become potential parties to the relationship and whose own interests may diverge from those of the couple."<sup>84</sup> Thus, in this setting the state gains wholesale power to intervene and regulate or proscribe gestational markets.

In addition, the right of privacy does not protect one's right to procreate if it conflicts with or is opposed by another person's right *not* to procreate. In *Davis v. Davis*, the court implied that a donor's interest outweighed the interests of the state, finding that "the state's interest in potential human life is insufficient to justify an infringement on the gamete-provider's procreational autonomy . . . [because] no other person or entity has an interest sufficient to permit interference."<sup>85</sup> Thus, the state lacks the power to intervene in assisted reproduction and may do so only to regulate or proscribe it if the state finds that the use of particular methods pose a threat to the resulting children.<sup>86</sup>

Although the ability to purchase semen from an anonymous donor may not be a guaranteed right, if it is allowed by the state, it is unlikely that the sperm

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80. Such justifications may include that A.I.D. is not in a child's best interest if the woman is unmarried, that single parent families burden state resources, and that the state needs to act in order to discourage illegitimate births. Kern & Ridolfi, *supra* note 67, at 253.

81. Garrison, *supra* note 8, at 855.

82. Rao, *supra* note 16, at 1084.

83. *Id.* at 1117. See also *Scouting the Frontiers of the Law*, *supra* note 45, at 25 (right to reproduce does not include right to get into a sperm clinic, in vitro fertilization program, or surrogate mother program).

84. Rao, *supra* note 16, at 1117.

85. 842 S.W.2d 588, 602 (Tenn. 1992) (court found that right of privacy encompasses both the right to procreate and right to avoid procreation and here, husband's right not to procreate outweighed his former wife's right to procreate).

86. See Rao, *supra* note 16, at 1117 n.224.



donor will interfere with the relationship of the mother and her resulting child.<sup>87</sup> The donor's anonymity will most likely preclude any donor attempts to enter the relationship. Anonymity is likely to prevent the existence of conflicts among the parties to the protected relationship, providing all involved a shield from state intrusion under the right of privacy.<sup>88</sup> Therefore, the couple is able to conceive and raise a child free from intrusion by the sperm donor. Moreover, if the donor's identity remains anonymous, the couple is further shielded from intrusion by the state in promoting the interests of the anonymous donor in seeking to establish a relationship with the resulting child.

If artificial insemination is performed with a known donor, however, the establishment of a relationship between the child conceived and the sperm donor, who is the biological father, may be in the child's best interests.<sup>89</sup> Thus, the state may choose to preserve the sperm donor's relationship with the child, valuing such a relationship more highly than maintaining the right to privacy and integrity of the family who obtained artificial insemination. In this context, a family who uses A.I.D. to conceive a child is not able to raise their child free from intrusion by the state, which is claiming to promote the best interests of the child. Thus, guarantees of the right to procreate using A.I.D. are subject to limitations.

## II. THE MOST RECENT CASE TO ADDRESS A SPERM DONOR'S RIGHT OF PRIVACY IN A DISCOVERY PROCEEDING

Recently the California Court of Appeals addressed whether the identity of an anonymous sperm donor should be disclosed in a discovery proceeding.<sup>90</sup> The *Johnson* decision sets an initial precedent for donor anonymity because it is the first case in the nation to directly address a donor's right of privacy in artificial insemination.

Similar to many other states, California's "constitutional right of privacy is broader and more protective of privacy than the implied federal constitutional right of privacy interpreted by federal courts."<sup>91</sup> Therefore, right of privacy

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87. *Id.* at 1120. *But see* ROBERTSON, *supra* note 49, at 38-39 (finding a constitutional right to purchase sperm, eggs, and gestational services).

88. *See* Rao, *supra* note 16, at 1099, 1106-07 (relational right of privacy protects formation and preservation of family-like relationships in absence of any conflict within biological family, thus right of privacy shields activities of only those who are allied against the state from governmental intrusion); Kern & Ridolfi, *supra* note 67, at 260 (constitutional cases establish that right of privacy prevents a state from intruding unnecessarily upon private relationships and concerns of family unit).

89. *See infra* notes 135-37 and accompanying text; *Scouting the Frontiers of the Law*, *supra* note 45, at 24 (although people have the right to reproduce and raise families, "we do want to look out for the interests of children who are going to come into the world").

90. *See Johnson v. Superior Court*, 95 Cal. Rptr. 2d 864, 871 (Ct. App. 2000), *review denied*, Aug. 23, 2000.

91. *Planned Parenthood Golden Gate v. Superior Court*, 99 Cal. Rptr. 2d 627, 636 (Ct. App.

analysis in the context of artificial insemination under California law is likely to be extended to other states. Since the *Johnson* court faced such an important issue in the context of a discovery proceeding, it is important to examine the law with regard to the right of privacy in a discovery proceeding before discussing the outcome of the case.

*A. Right of Privacy as a Means to Preclude the Disclosure of One's Identity in Discovery Proceedings*

Generally, discovery proceedings allow a party to obtain the identity and location of all persons having knowledge of any discoverable matter.<sup>92</sup> This applies equally to the discovery of information from nonparties and parties to a pending suit.<sup>93</sup> However, a privilege or other right may preclude the right to discover certain information about a person.<sup>94</sup> Such privileges include the right to be free from self-incrimination, the attorney-client privilege, the marital communications privilege, the spousal testimonial privilege, and the physician-patient privilege, which is recognized by many states.<sup>95</sup> A right that may further preclude discovery is a guarantee of anonymity in a contractual agreement, provided that such a contract does not conflict with public policy. Finally, the right of privacy may preclude discovery.

Whether a recognizable privacy interest precludes disclosure during discovery depends upon the balance of competing interests at issue. The right of civil litigants to discover relevant facts must be balanced against the privacy interests of the person subject to discovery.<sup>96</sup> As previously discussed, a compelling countervailing state interest may outweigh a person's right to privacy. However, in a discovery proceeding, "[t]he least intrusive means should be utilized to satisfy the state's countervailing interest."<sup>97</sup> Thus, a person's right of privacy in a discovery proceeding may not be infringed upon in the absence of

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2000).

92. See FED. R. CIV. P. 26(b)(1); see also *Johnson*, 95 Cal. Rptr. 2d at 871.

93. See FED. R. CIV. P. 26(b)(1).

94. See *id.*

95. See U.S. CONST. amend. V; FED. R. EVID. 501; U.S.C.S. FED. R. EVID. (2001) (Commentary) (virtually every state has legislatively recognized a physician-patient privilege). See also *Jaffe v. Redmond*, 518 U.S. 1 (1996) (Court recognized psychotherapists-patient privilege under federal law); *Trammel v. United States*, 445 U.S. 40 (1980) (privilege against adverse spousal testimony); *Fisher v. United States*, 425 U.S. 391 (1976) (attorney client privilege); *United States v. Lofton*, 957 F.2d 476 (7th Cir. 1992) (marital communications privilege). See generally Frank O. Bowman, III, *A Bludgeon by Any Other Name: The Misuse of "Ethical Rules" Against Prosecutors to Control the Law of the State*, 9 GEO. J. LEGAL ETHICS 665, 695 (1996).

96. *Johnson*, 95 Cal. Rptr. 2d at 878 (citing *Vinson v. Superior Court*, 43 Cal. 3d 833, 842 (1987)).

97. *Planned Parenthood Golden Gate v. Superior Court*, 99 Cal. Rptr. 2d 627, 636 (Ct. App. 2000) (convenience of means and cost will not merely satisfy the "compelling interest" test because if it did, expediency, rather than compelling interests, would represent overriding value).



compelling state interests.

*B. Outcome of Johnson v. Superior Court*<sup>98</sup>

In *Johnson*, Sperm Donor No. 276 fully disclosed his family medical history to California Cryobank, Inc.<sup>99</sup> This medical history included red flag indicators of the possible presence of Autosomal Dominant Polycystic Kidney Disease (A.D.P.K.D.) in the donor's family. Thus, the doctors at Cryobank possessed information indicating that Donor No. 276's sperm could be at risk of genetically transferring a kidney disease to any resulting children.

A husband and wife, Ronald and Diane Johnson, went to Cryobank to use the services of A.I.D. in order to conceive a child. The couple signed a confidentiality agreement providing that "Cryobank shall destroy all information and records which they may have as to the identity of said donor, it being the intention of all parties that the identity of said donor shall be and forever remain anonymous."<sup>100</sup>

Cryobank assured the Johnsons that the sperm from the anonymous sperm donor had been genetically tested and screened for diseases and irregularities, and that the sperm was healthy.<sup>101</sup> Mrs. Johnson was artificially inseminated and, thereby, conceived a child. Six years later, however, the child was diagnosed with A.D.P.K.D. The court established that the donor genetically transmitted the A.D.P.K.D. to the child, since neither parent had any history of the disease in their families.<sup>102</sup> The parents filed a claim against the sperm bank alleging professional negligence, fraud, and breach of contract, asserting that the sperm bank falsely represented that the sperm had been tested and screened and was free of infectious and genetically transferable diseases.

During the course of the proceedings, the Johnsons asserted the right to depose the sperm donor and to obtain his identity and all of his medical information.<sup>103</sup> The trial court quashed the deposition subpoena, ruling that the sperm donor had a privacy interest in remaining anonymous, which was heightened by the confidentiality agreement signed by the Johnsons and Cryobank.<sup>104</sup> The court further found that the petitioners had not demonstrated a compelling state interest that outweighed the donor's right to remain anonymous.<sup>105</sup> Finally, the trial court determined that the donor would not provide any new insight into the child's medical condition.<sup>106</sup>

The Johnsons appealed, and the court of appeals ordered the trial court to

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98. 95 Cal. Rptr. 2d at 864.

99. *Id.* at 868.

100. *Id.* at 867.

101. *Id.*

102. *See id.* at 868.

103. *Id.* at 867.

104. *Id.* at 870.

105. *Id.*

106. *See id.*

vacate its order and grant petitioners' motion to compel discovery.<sup>107</sup> However, the court of appeals recommended that the trial court grant an alternative order to protect the donor's identity to the fullest extent possible.<sup>108</sup> Limited attendance at the deposition and the use of the name "John Doe" in the transcript were two methods suggested by the court.<sup>109</sup>

Thus, the child conceived by A.I.D. and her parents could compel the donor's deposition and production of documents to discover information relevant to the action because such discovery might produce the identity and location of a person holding information relevant to the case. The court further determined that a privilege or right did not exist to preclude discovery of the sperm donor's identity.

First, the physician-patient privilege did not apply to prevent disclosure of the donor's identity because Donor No. 276 did not consult a physician for diagnosis or treatment of a physical or mental ailment.<sup>110</sup> Instead, the donor visited Cryobank for the sole purpose of selling his sperm. Thus, the sperm donor was not able to assert this privilege in order to preclude discovery of his identity.

In addition, the court found that Cryobank's confidentiality agreement with the Johnsons did not preclude disclosure of the donor's identity.<sup>111</sup> The court acknowledged that the donor had standing as a third-party beneficiary via the contract between the Johnsons and Cryobank. Furthermore, all parties agreed that the donor's identity and related information be kept confidential.<sup>112</sup> However, the court nevertheless found that the contract went too far by "precluding disclosure of the donor's identity and related information under *all* circumstances."<sup>113</sup> Thus, the contract conflicted with public policy and was found to be void.<sup>114</sup> The court held that "a contract that completely forecloses the opportunity of a child conceived by artificial insemination to discover the relevant and needed medical history of his or her genetic father is inconsistent with the best interests of the child."<sup>115</sup>

Furthermore, the court found that the donor's limited constitutional right to privacy did not preclude disclosure of the donor's identity.<sup>116</sup> The Court began by determining that the donor possessed a legally recognized privacy interest because the medical history of any person clearly falls within the recognized zone of privacy.<sup>117</sup> However, the court found this interest to be a limited privacy

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107. *Id.* at 879.

108. *See id.* at 878.

109. *Id.*

110. *Id.* at 872.

111. *See id.* at 872-73.

112. *Id.* at 873.

113. *Id.* (emphasis in original).

114. *Id.* at 875.

115. *Id.*

116. *See id.* at 878-79.

117. *Id.* at 878.



right, basing its decision on two reasons. First, California state law provides that “[a]ll papers and records pertaining to the insemination . . . are subject to inspection only upon an order of the court for good cause shown.”<sup>118</sup> The court reasoned that this statutory language revealed an intention by its framers to create a limited privacy interest for sperm donors.<sup>119</sup>

Second, the court found that the donor did not possess a reasonable expectation of privacy under the circumstances.<sup>120</sup> Cryobank routinely told its sperm donors that non-identifying medical history and related information could be disclosed to the purchasers of the sperm. Furthermore, the court found that the donor’s expectation “was substantially diminished” by his own conduct.<sup>121</sup> In light of the donor’s clear connection with Cryobank involving commercial transactions of over 320 semen deposits, the court found it unreasonable for the donor to expect that his genetic history and identity would never be disclosed. The connection between the donor and the sperm bank was not only substantial; it was also likely to affect the lives of many people because of its potential to contribute to the creation to the human life. Therefore, the court found any expectation the donor had that his privacy would be completely protected was unreasonable.<sup>122</sup> Thus, while the donor possessed a legally recognized privacy right, the right was limited.

The court next addressed the issue of whether the discovery sought by the Johnsons exceeded the boundaries of the donor’s limited privacy interests.<sup>123</sup> The Johnsons sought the donor’s deposition to learn all of the relevant facts he disclosed to Cryobank, including his medical history and any indications of the presence of the hereditary kidney disease A.D.P.K.D. The Johnsons also sought access to all of the donor’s records pertaining to his family’s medical history of A.D.P.K.D. and related symptoms. The information requested by the Johnsons included not only the identity and medical history of the donor, but also that of his family. Therefore, the court found that such broad discovery requests constituted a serious invasion of the donor’s privacy.<sup>124</sup>

However, despite the Johnson’s discovery request constituting a serious invasion of the donor’s privacy, the court held that such an invasion of privacy

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118. *Id.* at 876 (quoting CAL. FAM. CODE § 7613 (West 1994)).

119. *See id.*

120. *Id.* at 877. *See also* *Rosales v. City of Los Angeles*, 82 Cal. Rptr. 2d 149 (2000) (peace officer has no expectation of privacy concerning personnel records in litigation by third party against employee due to officer’s conduct); *Hill v. Nat’l Collegiate Athletic Ass’n*, 865 P.2d 633 (Cal. 1994) (athletes have diminished expectation of privacy with regard to observation during urination and medical information relevant to drug testing); *People v. Martinez*, No. H021193, 2001 WL 357789, at \*6 (Cal. Ct. App. 2001) (citing *Johnson* case and parenthetically describing its holding as: “sperm donor has reduced expectation of privacy concerning disclosure of nonidentifying medical information”).

121. 95 Cal. Rptr. 2d at 878.

122. *Id.*

123. *Id.*

124. *Id.*

was justified by compelling state interests.<sup>125</sup> These state interests included requiring parties to comply with properly served discovery requests, seeking the truth in court proceedings, and ensuring those injured by the actionable conduct of others receive full redress of those injuries.<sup>126</sup> Furthermore, the Johnsons demonstrated that the donor was the only witness who could reveal the nature and extent of the information he had disclosed upon donating his sperm to Cryobank. Such information was crucial to the Johnsons because in order for them to make a successful case against the sperm bank, they had to prove that the sperm donor had disclosed warning symptoms indicating that his sperm could potentially carry A.D.P.K.D. Such information would provide the evidentiary link necessary to prove that Cryobank knowingly misrepresented that the sperm used in the artificial insemination was free from genetic diseases.<sup>127</sup>

### III. EFFECTS OF THE *JOHNSON* DECISION

#### A. *Abolishing the Guarantee of Sperm Donor Anonymity in Artificial Insemination*

The *Johnson* decision sets precedent in donor anonymity law because it is the first case to directly address a donor's right of privacy in A.I.D. However, the decision makes it potentially difficult to protect a donor's right of privacy in maintaining anonymity. By finding that a sperm donor possesses merely a limited right to privacy, the *Johnson* court opened the door to infringing upon a donor's anonymity in order to promote something less than a compelling state interest. In the future, merely important or even rational state interests may suffice to outweigh the sperm donor's mere *limited* right to privacy.

Of course, certain interests should qualify as justified infringements of the donor's anonymity. A child conceived by A.I.D. who has developed a genetic disease should have the ability to ascertain the donor's identity to gain information about the donor's family medical history, since such information could lead to early disease detection and a more positive prognosis. Such information is critical considering that hereditary disorders, which may not develop until years later, can be life-threatening if not properly diagnosed and treated.<sup>128</sup> One may posit that access to merely medical records and not the donor's identity would suffice; however, "many times the medical histories of

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125. *Id.*

126. *Id.*

127. *Id.*

128. "[Adoptive] [c]hildren with physical or genetic disorders underwent painful and sometimes hazardous testing[,] . . . experienced delayed recovery, or suffered permanent disability" that may have been avoided had the birth parents' medical information been available or revealed to the adoptive parents. D. Marianne Brower Blair, *The New Oklahoma Adoption Code: A Quest to Accommodate Diverse Interests*, 33 TULSA L.J. 177, 257-58 & nn.477-78 (1988). A child with familial polyposis, for example, will develop symptoms late in childhood and experience carcinoma of the colon if left untreated. *Id.* at 258 n.478.



donors are superficial, incomplete, or extremely outdated[,]” making contact with the donor himself essential.<sup>129</sup> Additionally, the donor’s identity and medical history should be revealed if a child conceived by A.I.D. needs a bone marrow or kidney transplant since finding a biological relative may mean the difference between life and death.<sup>130</sup> Such infringements on the donor’s right of privacy are warranted because these disclosures could save the A.I.D. child’s life, thus promoting truly compelling interests.

However, the *Johnson* court did not infringe upon the donor’s anonymity to enable the Johnsons to obtain additional information about the child’s disease in order to treat or diagnose the child. Rather, the court did so to enable the Johnsons to gain the necessary information to build a successful lawsuit against the sperm bank, placing more importance upon the Johnsons’ ability to create a legal defense than on the sperm donor’s right of privacy. The court emphasized the state’s interest in “ensuring that those injured by actionable conduct of others receive full redress of those injuries.”<sup>131</sup> However, in *Johnson*, the sperm donor was not the party responsible for the actionable conduct; it was the sperm bank who falsely represented that the sperm had been screened and was free of infectious and genetically transferable diseases. Nonetheless, the court deemed the Johnsons’ discovery interests compelling, warranting an invasion into the donor’s privacy.<sup>132</sup>

However, a court’s desire to ensure that an efficient and just legal process occurs may not outweigh the need to create safe methods and means of conception for infertile couples. The constitutionally protected rights to procreate and raise a family have been held to demand the utmost priority.<sup>133</sup> Therefore, while the court in *Johnson* found the discovery interests to be compelling, thus supporting its decision that disclosure of the donor’s anonymity was justified, in the future, merely important or even rational state interests may suffice to warrant disclosure of the donor’s anonymity.

Whether a recognizable privacy interest precludes disclosure during discovery depends upon a balance of the competing interests at issue. The need for civil litigants to discover relevant facts must be “balanced against the privacy interests of the persons subject to discovery.”<sup>134</sup> By determining that the sperm

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129. Kristen E. Koehler, *Artificial Insemination: In the Child’s Best Interest?*, 5 ALB. L.J. SCI. & TECH. 321, 330 (1996); *Johnson*, 95 Cal. Rptr. 2d at 875 (situations may require the disclosure of the donor’s identity in order to obtain the needed genetic and medical information).

130. See Swanson, *supra* note 1, at 175; *Johnson*, 95 Cal. Rptr. 2d at 875 (court found “[i]n some situations, a person’s ability to locate his or her biological relative may be important in considering lifesaving transplant procedures”).

131. *Johnson*, 95 Cal. Rptr. 2d at 878.

132. *Id.* (compelling state interests included: making parties comply with properly served discovery requests, seeking truth in court proceedings, and ensuring those injured by actionable conduct of others receive full redress of those injuries).

133. See Kerian, *supra* note 79, at 158 (protecting one’s “constitutional rights to privacy and procreation is the highest priority”).

134. *Johnson*, 95 Cal. Rptr. 2d at 878 (citing *Vinson v. Superior Court*, 43 Cal. 3d 833, 842

donor's privacy interest was limited, however, the court of appeals in *Johnson* tipped the scale in favor of the party seeking to discover information about the sperm donor. Therefore, the party needs only to have an interest more compelling than the sperm donor's *limited* privacy interest to warrant disclosure and infringement of the donor's right to remain anonymous.

In future decisions, therefore, less compelling interests may suffice to outweigh the donor's privacy interest. For example, courts may find that a child's desire to learn about his or her parental roots and family heritage are important enough to infringe upon a donor's anonymity because these are important interests to promote the well being of a child.<sup>135</sup> Many psychologists claim that the inability to discover one's biological roots may be quite harmful to a child, resulting in insecurity and an underdeveloped sense of identity.<sup>136</sup> Thus, the desire of an A.I.D. child to establish contact with his or her biological father may also be deemed an important state interest justifying infringement on donor anonymity because it promotes a child's interest in developing a relationship with his or her biological father.<sup>137</sup>

As a result, courts and legislatures may determine that children conceived by

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(1987)). See also *Planned Parenthood Golden Gate v. Superior Court*, 99 Cal. Rptr. 2d 627, 643 (Ct. App. 2000) (disclosure of information which is essential to fair resolution of lawsuit may properly be compelled).

135. Many people believe it is important to recognize a child's birthright to obtain heredity information. See N.P.R.: Morning Edition, *Analysis: California Supreme Court Ruling on the Anonymity of a Sperm Donor That Could Affect Fertility Clinics Nationwide*, Aug. 25, 2000, available at 2000 WL 21481375. Many adult adoptees have a compelling psychological need for information about their heritage. See Blair, *supra* note 128, at 247.

136. See Swanson, *supra* note 1, at 178-79 (this psychological problem has been classified as "genealogical bewilderment"); Blair, *supra* note 128, at 247 n.415 (effects of "genealogical bewilderment" may include a state of confusion and uncertainty in adoptees who become obsessed with questions regarding their biological roots or identity crisis in adopted adolescents manifested by social and psychological dysfunction); Carvel, *supra* note 20 ("there is evidence of confusion and insecurity among children who have been told they were conceived by artificial insemination, but denied further information about their biological parent . . .").

137. Many A.I.D. children desire information regarding their biological fathers when they become adults. See Margaret R. Brown, *Whose Eyes Are These, Whose Nose?*, NEWSWEEK, Mar. 7, 1994, at 12 (discussing an adult conceived by A.I.D. who desires information about her biological father); David Noonan & Karen Springen, *When Dad is a Donor*, NEWSWEEK, Aug. 13, 2001, at 46-47 (discussing two children conceived by A.I.D. who are now adults hunting for their biological fathers and noting "there is the growing desire among donor children to unravel the mystery of their origins"); Peggy Orenstein, *Looking for a Donor to Call Dad*, N.Y. TIMES, June 18, 1995, § 6 (Magazine), at 1 (reporting accounts of A.I.D. children who want to obtain information about their biological fathers). See also Melissa Fletcher Stoeltje, *Adopted Teens Seek Answers*, HOUS. CHRON., May 28, 1997, at 1 (sixty-five percent of adopted adolescents teenagers say they want to meet their birth parents); Karen M. Thomas, *The Donor Connection: Families Are Chipping Away at the Tboos [sic] and Secrecy that Once Surrounded Artificial Insemination*, DALLAS MORNING NEWS, Nov. 23, 1997, at 1F.



A.I.D. have the same informational needs as adoptive children.<sup>138</sup> This may lead to the enactment of A.I.D. laws analogous to current adoption laws, which allow the discovery of biological parent information by adoptive children.<sup>139</sup> Alternately, in the absence of legislation, courts may develop common law that closely imitates adoption laws, allowing disclosure of donor identity and easy access to revealing information about the donor. Such situations would create a trend for additional infringements on a donor's right of privacy, making it much more difficult for a donor to remain anonymous.

Furthermore, additional state interests promoting what is best for the A.I.D. child may be found to constitute the necessary interest to justify infringement on donor anonymity. Because sperm donors are allowed to donate numerous times at a sperm bank, one sperm donor may father numerous children in the same geographic area. There are no laws that regulate the number of children a donor can father; however, the American Fertility Society, recognizing the severity of such a problem, has recommended a ten-pregnancy limit for populous areas and less than ten pregnancies for less-populous areas.<sup>140</sup> However, sperm banks and physicians are not required by law to adhere to this limit. Anonymity, therefore, may lead to half-siblings unknowingly mating and subsequent genetic difficulties in conceived children<sup>141</sup> illustrating another interest that may suffice to outweigh that of the donor's limited right of privacy.

Thus, the *Johnson* decision paves the road for courts and legislatures to make it extremely difficult to protect a donor's right of privacy in maintaining anonymity in artificial insemination. As a result, a sperm donor increasingly faces the potential loss of his anonymity.

Furthermore, the court in *Johnson* eliminated the guarantee of donor anonymity by abolishing the ability to ever contractually promise anonymity in sperm donation contracts. Therefore, the recipients of A.I.D. may not even provide by contract that the donor's identity will never be revealed. The court reached this result by ruling that "a contract that completely forecloses the opportunity of a child conceived by artificial insemination to discover the relevant and needed medical history of his or her genetic father is inconsistent with the best interest of the child."<sup>142</sup> Despite the clear intention of all parties involved to keep the identity of the donor anonymous, the court voided the contract by finding that the confidentiality contract went "too . . . far [by] precluding disclosure of the donor's identity and related information under *all*

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138. Garrison, *supra* note 8, at 898.

139. *Id.* at 899 (adoption records are kept on file for generations, allowing adoptive families to have enough information about adoptive child's biological information to satisfy their own psychological needs).

140. See Swanson, *supra* note 1, at 177. See, e.g., Briggs, *supra* note 4, at G1.

141. See Durkin, *supra* note 53, at 338 n.82 (citing Ann T. Lamport, *The Genetics of Secrecy in Adoption, Artificial Insemination, and In Vitro Fertilization*, 14 AM. J.L. & MED. 109, 116-17 (1988)).

142. *Johnson v. Superior Court*, 95 Cal. Rptr. 2d 864, 875 (Ct. App. 2000), *review denied*, Aug. 23, 2000.

circumstances. . . .<sup>143</sup>

Therefore, confidentiality agreements, which are so prevalent in sperm bank services, even if they articulate intent by *all* parties involved to maintain anonymity, will, pursuant to *Johnson's* direction, violate public policy and, therefore, be void. Thus, the recipients of A.I.D. lose the ability to provide by contract that the donor's identity or the identity of their child will never be revealed.

In contradiction to the *Johnson* court's ruling, it might be in the best interests of society if the sensitive issues surrounding assisted reproduction were dealt with by contracts, thereby forcing all parties involved to reflect upon their procreative intentions prior to insemination.<sup>144</sup> Such forethought may, in fact, act as a cautionary measure, ensuring parties enter such situations fully aware of the potential consequences involved. Regardless, the court found such contracts to be void as against public policy, thereby abolishing contract as a means to guarantee donor anonymity. Thus, by limiting a sperm donor's right of privacy and abolishing the opportunity of A.I.D. recipients to contractually promise privacy, the court in *Johnson* has made donor anonymity difficult to maintain.

*B. Jeopardizing the Ability of the Couple Utilizing A.I.D. to Conceive and Raise a Family Free from Intrusion*

Many families who conceive by means of A.I.D. assume that easier access to a sperm donor's identity promotes the well-being of their child and family. The ability to obtain medical and genetic information without dispute is extremely appealing. However, finding a limited right of privacy for the sperm donor, while it appears to be beneficial to the A.I.D. child and family, may in fact result in more harm than benefit to the family and child.

The guarantee of anonymity protects the child conceived by A.I.D., the parents who participated in A.I.D., and the sperm donor who donated his gametes for A.I.D. from emotional distress.<sup>145</sup> An A.I.D. child's desire to learn about his parental roots and heritage and to establish contact with his or her biological father has the potential to strain the existing family unit. Acting on these desires would not be an option if donor anonymity were guaranteed and, as a result, the familial unit of the couple who participated in A.I.D. would be preserved. Furthermore, donor anonymity shields families from a donor's claims of inheritance rights and involvement in the issues of the child's paternity and legitimacy.<sup>146</sup>

Moreover, anonymity is important to a family desiring to keep their decision to resort to A.I.D. secret.<sup>147</sup> The family may fear shame or ridicule if such

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143. *Id.* at 873 (emphasis in original).

144. See Brenwald & Redeker, *supra* note 66, at 629-30.

145. See Swanson, *supra* note 1, at 171.

146. See *id.*

147. See Garrison, *supra* note 8, 897 n.284 (citing Julian N. Robinson et al., *Attitudes of Donors and Recipients to Gamete Donation*, 6 HUM. REPROD. 307, 308 (1991), who wrote that



information were revealed within their nuclear and extended families or community. Alternatively, the family may just want others to believe the child is the offspring of the husband. Furthermore, the couple's religion may even forbid use of assisted reproduction. Thus, one's religious beliefs may cause all parties involved in the artificial insemination process to maintain secret identities in order to shield themselves from criticism.<sup>148</sup> In addition, the couple may choose not even to reveal the use of A.I.D. to their child conceived by such means.<sup>149</sup> Finally, a later reappearance by the sperm donor might drastically disrupt a family who had made such privacy decisions and greatly impact their unity and image in the community.

However, some scholars posit that societal attitudes to A.I.D. have changed radically, resulting in a greater willingness on the part of sperm donors and family recipients of A.I.D. to relinquish their secrecy and anonymity.<sup>150</sup> "[T]he growing numbers of couples who use A.I.D. and their openness about it, testify to society's growing acceptance of the procedure. . . . Thus, participants' demand for donor anonymity has weakened considerably over time."<sup>151</sup>

Yet, eliminating the threat of reappearance by the biological father and disruption of the family remains a critical aspect of maintaining donor anonymity in order to promote a family's interests. Choosing an anonymous donor will most likely preclude any of his attempts to enter into a relationship with the child conceived so that all of the parties involved are shielded from state intrusion under the right of privacy.<sup>152</sup> The best way to ensure that the donor is not able to later claim paternity or establish a relationship with the child is to maintain donor anonymity.<sup>153</sup> If the donor remains anonymous, the couple artificially

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eighty-five percent of parents "stated that they would conceal the nature of their offspring's conception"); Noonan & Springen, *supra* note 137, at 46 ("some couples went so far as to use one doctor to get pregnant and another to deliver the baby, without telling the second doctor how the child was conceived"); *see also* Milk, *supra* note 2, at 65 ("[e]ighty percent of the married couples who came to the Fairfax Cryobank want a donor who looks like the husband. . . . [because] the husband planned to tell no one—not even immediate family—that the child wasn't his"); Jim Nolan, *Banking on Birth: More and More Women Take the Mate Out of Mating by Seeking Out Sperm Donors*, THE SPOKESMAN-REV. (Spokane, Wash.), Aug. 17, 1998, at B3 ("[h]eterosexual couples confronted with male infertility almost always seek a donor who matches the physical characteristics of the husband").

148. Swanson, *supra* note 1, at 164.

149. Noonan & Springen, *supra* note 137, at 46 ("following World War II, embarrassed couples who used donor insemination rarely told anyone where their babies come from, including the children themselves").

150. *See id.* ("the presumption was that infertile men couldn't handle more-open door insemination", but "now the social terrain has shifted dramatically" and stigmas and secrecy are falling away); Swanson, *supra* note 1, at 168-70.

151. Swanson, *supra* note 1, at 171.

152. *See* Rao, *supra* note 16, at 1117.

153. States that have enacted laws modeled after the U.P.A. which sever unknown donors' rights with regard to the child conceived, accomplish such safeguards for the A.I.D. participant

inseminated is shielded from intrusion by the state in promoting the interests of the anonymous donor to foster a relationship with the child. Therefore, the couple is able to conceive and rear a child free from intrusion by the sperm donor.

If the identity of the sperm donor is revealed, however, the donor may be included within the relationship protected by the right of privacy.<sup>154</sup> A state may find that establishing a relationship between the conceived child and the sperm donor, who is the biological father, is in the child's best interests.<sup>155</sup> Thus, the state may choose to preserve the sperm donor's relationship with the child, valuing such a relationship more than maintaining the integrity of the family who obtained artificial insemination and a right to privacy in that transaction. In such an instance, a family who uses A.I.D. to conceive a child is not able to raise their child free from intrusion by the state, as intrusion would be justified under the rubric of the best interests of the child.

The possibility that a sperm donor may indeed desire to establish a claim of paternity or a relationship with his biological child is a potential threat to the recipient family.<sup>156</sup> While the court in *Johnson* presumed that sperm donors are motivated to donate merely for financial incentives, this may not always be the case. In *Johnson*, the court specifically made note of the fact that the donor had deposited over 320 specimens of his semen with Cryobank, earning over \$11,000.<sup>157</sup> From this, the court established that the donor's relationship with Cryobank was a substantial commercial transaction.<sup>158</sup> However, a donor's decision to donate may be based on his desire to ensure the advancement of his genetic likeness despite, for whatever reason, his inability to do so otherwise.<sup>159</sup> If so, his later desire to contact a resulting biological child may be likely. Furthermore, a donor may initially be motivated to donate for financial gain, but

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family. However, many scholars negatively critique such laws because they belittle and trivialize "the importance of fathers or send[] the message to society that biological fatherhood does not entail corresponding responsibility." Michael L. Jackson, *Fatherhood and the Law: Reproductive Rights and Responsibilities of Men*, 9 TEX. J. WOMEN & L. 53, 91 (1999).

154. See Rao, *supra* note 16, at 1117.

155. See *infra* notes 135-37 and accompanying text.

156. See Noonan & Springen, *supra* note 137, at 47 (discussing one man who anonymously donated sperm thirty-five times two decades ago and is currently searching for his offspring).

157. *Johnson v. Superior Court*, 95 Cal. Rptr. 2d 864, 867 (Ct. App. 2000), *review denied* Aug. 23, 2000.

158. *Id.*

159. One existing sperm bank specializes in the artificial insemination of sperm donated by Nobel laureates and Olympic champions and does not even pay its donors for their specimens. *Owner of "Genius" Sperm Bank Pleased by Results*, N.Y. TIMES, Dec. 11, 1984, at A17. Robert Graham is the founder of the Repository for Germinal Choice in Escondido, California, a sperm bank which draws sperm from the brightest one percent of scientists, businessmen, and professionals, including Nobel laureates. See Christopher Goodwin, "Nobel Sperm Bank" Babies . . . and How They Grew: Case Histories Vary as Children of Wealthy Man's "Genius" Project Come of Age, TORONTO STAR, Jan. 16, 2000, at B51; Chase, *supra* note 4.



may later find himself desiring to maintain a relationship with his biological child. Thus, his desire to intrude upon the recipients of A.I.D. will pose a real threat to the A.I.D. child and family.

Another critical question raised by the *Johnson* decision addresses whether the *child's* right of privacy is also compromised. Assume, for example, that years after providing a donation, a sperm donor develops a rare hereditary disease of which he had been unaware of his predisposition. In this hypothetical, one must query whether the sperm donor will be afforded the same opportunity to obtain the identity of the child conceived by artificial insemination in order to convey pertinent medical information that may save the child's life through early detection.

If a court were to extend the decision in *Johnson* to address this question, it would have to find that the child conceived by A.I.D. had a limited right to privacy, just as the sperm donor did, employing the rationale that it is in the A.I.D. child's best interest for the donor to obtain his identity in order to contact the child and inform him of the disease. Revealing the child's identity promotes the state's compelling interest of protecting the child's life as well as the lives of any offspring the child might already have had. This compelling interest in promoting the A.I.D. child's life, safety, and well-being, as well as those of his offspring, would outweigh his own right to privacy. Furthermore, the state would have a compelling interest in preventing the A.I.D. child from further transmitting any genetic defects.<sup>160</sup> The state could take the steps necessary to prevent the spread of infectious diseases by helping to avoid the transmission of genetic defects.<sup>161</sup> Therefore, under this rationale, the A.I.D. child should be notified, which would only be possible if the sperm donor is able to contact him directly or indirectly, justifying any infringement on the A.I.D. child's right of privacy.

Alternatively, assume that after providing a sperm donation, the donor himself conceives a child naturally. Assume also that this child is born with, or later develops, a rare heredity disease. Under an extension of *Johnson*, the donor should be able to obtain the identity of the A.I.D. child to either inform him or caution him to be tested or, in the alternative, to learn whether the A.I.D. child has already contracted the same disease and gain information about his condition or possible treatments. Under this scenario, such information may save the life of the sperm donor's own naturally born child. The state would again have a compelling interest in promoting the natural child's life, safety, health, and well being, and these interests would outweigh the A.I.D. child's right of privacy, justifying disclosure of his identity to the sperm donor.

This same reasoning can similarly be applied to a situation where a naturally born child is in need of a bone marrow or kidney transplant. It may be critical for the donor to contact the A.I.D. child, who may be the only available match to save the life of the donor's naturally born child. Saving the naturally born child's life is clearly an important state interest. Once again, the A.I.D. child's

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160. Swanson, *supra* note 1, at 175.

161. *Id.* at 184.

right of privacy would be outweighed by a compelling state interest, justifying disclosure of his identity to the sperm donor.

Thus, while many families think that easier access to a sperm donor's identity promotes the well-being of their A.I.D. child and family, such access may produce correlating harmful effects. Finding a limited right of privacy for the sperm donor, although it appears to be beneficial to the A.I.D. recipient family, may actually result in more harm than benefit. Consequently, a couple is no longer able to use A.I.D. in order to conceive and raise a family free from intrusion by the donor. Thus, the *Johnson* decision, in limiting a donor's ability to maintain anonymity, has also jeopardized the ability of A.I.D. participants to conceive and raise a family free from intrusion by the anonymous donor and the state.<sup>162</sup>

### C. Reducing the Amount of Sperm Donors

Finding that sperm donors possess merely a limited privacy interest may also reduce the number of sperm donors. "[P]otential loss of anonymity might conceivably have a significant impact on donor decision making."<sup>163</sup> Men may be less likely to become donors if they feel they are faced with the prospect that in the future, someone could show up on their doorstep claiming to be their biological child.<sup>164</sup> If never having their identity revealed is of paramount concern to sperm donors, doctors need to be able to guarantee donor anonymity to insure a continuous donor pool.<sup>165</sup>

The willingness of a man "to donate his semen is critical to the continued availability of AID as a means of conception."<sup>166</sup> If men are dissuaded from participating in the A.I.D. procedure, the results may include elimination of A.I.D. altogether or alternatively lead to an increase in costs of the procedure so that only the wealthy could afford it.<sup>167</sup> Any action that would impair access to A.I.D. detracts from a couple's right to reproduce.<sup>168</sup> It is the state's duty not to enact laws that discourage donors because doing so would amount to infringing upon an individual's right to procreate with the aid of reproductive technologies. Thus, if the loss of donor anonymity does indeed limit the supply of sperm available for A.I.D., then disclosure of the donor's identity would interfere with potential parents' right to procreate.<sup>169</sup>

However, many scholars assert that an increased potential for loss of

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162. See *Johnson v. Superior Court*, 95 Cal. Rptr. 2d 864, 864 (Ct. App. 2000), review denied Aug. 23, 2000.

163. Garrison, *supra* note 8, at 900.

164. Milk, *supra* note 2, at 65.

165. Kern & Ridolfi, *supra* note 67, at 253.

166. McIntyre, *supra* note 17, at 545.

167. See *id.*

168. See Swanson, *supra* note 1, at 181.

169. *Id.*



anonymity will not lead to a reduction in the amount of sperm donors,<sup>170</sup> with which the *Johnson* court agrees.<sup>171</sup> However, donors characteristically expect to remain anonymous upon donation, with a majority of sperm donors overwhelmingly favoring strict anonymity.<sup>172</sup> Many potential donors surveyed reported they would not choose to donate if their anonymity was not maintained.<sup>173</sup> Therefore, the threat of a diminished supply of sperm donors is a substantial risk associated with the judicial finding that a donor merely possesses a limited right to privacy, and must be considered in the enactment of

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170. See *id.* at 171-72 (there will not be shortage of sperm donors if anonymity is not guaranteed, and concern that “lack of donor anonymity will render the practice of AID impossible seems outdated”); Lori B. Andrews & Lisa Douglass, *Alternative Reproduction*, 65 S. CAL. L. REV. 623, 661 (1991) (reporting that seventy-five percent of donors surveyed at a California sperm bank were willing to provide identifying information to their child once they have reached the age of majority); Garrison, *supra* note 8, at 900 n.295 (citing Patricia P. Mahlstedt & Kris A. Probasco, *Sperm Donors: Their Attitudes Toward Providing Medical and Psychosocial Information for Recipient Couples and Donor Offspring*, 56 FERTILITY & STERILITY 747, 749-52 (1991), who indicate that sixty percent of the surveyed artificial insemination donors at two centers in Texas and Louisiana reported they were willing to meet with or provide identifying information to their biological child at age eighteen); Robin Herman, *When the “Father” Is a Sperm Donor: A New Look at Secrecy*, WASH. POST, Feb. 11, 1992, Health at 10 (directors at a sperm bank that offer donors a choice between anonymity and openness claim that it is no more difficult to recruit donors for open program than for program guaranteeing anonymity).

171. *Johnson v. Superior Court*, 95 Cal. Rptr. 2d 864, 878 (Ct. App. 2000), *review denied*, Aug. 23, 2000 (“[W]e question Cryobank’s contention that without complete confidentiality its business will suffer because it will be unable to attract donors. Research on the subject suggests that confidentiality is generally more of a concern to doctors than to donors”).

172. Koehler, *supra* note 129, at 332-33. See also Carvel, *supra* note 20 (England’s public health minister states that allowing children to learn identity of their biological parents will “deter donors who might reasonably fear they could be pursued by large numbers of unknown offspring seeking emotional and financial support. . . . Doctors and infertility support groups are concerned that relaxation of confidentiality rules could discourage potential donors . . . .”); Garrison, *supra* note 8, at 900 n.295 (citing Mark V. Sauer et al., *Attitudinal Survey of Sperm Donors to an Artificial Insemination Clinic*, 34 J. REPROD. MED. 362, 363 (1989), who indicate that survey of sperm donors at a California clinic revealed that seventy-one percent favored anonymity); Elizabeth L. Gibson, *Artificial Insemination by Donor: Information, Communication and Regulation*, 30 J. FAM. L. 1, 28 (1991-92); *Court Upholds Limit on Sperm Donors’ Privacy*, *supra* note 20, at A15 (Cryobank’s attorney fears the *Johnson* decision may scare away donors); Noonan & Springen, *supra* note 137, at 47 (sperm banks with “yes”-donor programs, in which donors agree in advance to let any offspring track them down when the children reach eighteen, report that most donors still prefer anonymity).

173. See Garrison, *supra* note 8, at 900 n.295 (citation omitted) (only twenty percent of the active donors at a Danish infertility clinic reported a willingness to continue donating if current rules of anonymity were revoked); Robinson et. al, *supra* note 147, at 30 (only fifteen percent of potential sperm donors surveyed in 1991 at two British artificial insemination centers would choose to donate if their anonymity were not maintained).

state laws. The state must not infringe upon the right to procreate with the aid of reproductive technologies. Thus, if the loss of donor anonymity does indeed limit the supply of sperm available for A.I.D., then the *Johnson* decision interferes with potential parents' right to procreate.

*D. A Redeeming Effect of the Johnson Decision: Decreasing the Number of Children Born with Genetic Diseases*

Finding that sperm donors possess merely a limited right of privacy may positively have the effect of reducing the number of children born with genetic diseases. By granting parties permission to depose the sperm donors, the court has created a means by which the participants of A.I.D. can obtain the necessary information to successfully bring a lawsuit against sperm clinics. The court has given parties the means to hold sperm banks accountable for misrepresentations. Participants of A.I.D. are no longer without recourse for false assurances that the sperm used in the insemination procedure was free from genetic defects.

Now that A.I.D. participants have access to a sperm donor's identity and related records, the threat of litigation is more of a reality to sperm banks. More vulnerable to attacks alleging misrepresentation, sperm clinics will be forced to screen both sperm donors and their donated gametes more carefully in order to avoid liability.<sup>174</sup> Sperm clinics will also be more reluctant to falsely convey that there are no signs of hereditary diseases in donor sperm when, in fact, the donor revealed such signs to the sperm bank upon donating. Knowing that the participants will be able to depose the sperm donor, who will reveal the information he conveyed at the time of donation, sperm banks face increased susceptibility to meritorious claims against them for false representation. Thus, an increased focus on genetic screening, and a reduction in the willingness to misrepresent the health of the sperm may lead to a reduction in the number of A.I.D. children born with genetic diseases.

Furthermore, to avoid litigation in the future, sperm clinics may implement policies that will encourage their sperm donors to more fully disclose hereditary information, thereby increasing donor screening processes. Under the current system, sperm donors are paid for their donations only if their semen has been first deemed acceptable for insemination, which creates monetary incentives for the donor to withhold information upon donation.<sup>175</sup> By implementing a new system in which donors are paid for their sperm regardless of its quality, the sperm bank would eliminate the incentive for sperm donors to misrepresent or withhold information and hence improve the likelihood that genetic diseases could be detected by the sperm bank. The donor would disclose more information, enabling sperm banks to perform more focused testing for the

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174. Regulations requiring screening of sperm for A.I.D. is not as thorough as it should be to protect participants. Many states merely require donors to screen potential donors for H.I.V., and a few require additional screening for other sexually transmitted diseases and genetic disorders. See Garrison, *supra* note 8, at 838 n.7.

175. McIntyre, *supra* note 17, at 523.



diseases that the donor indicates might be applicable. While such a policy may increase the sperm bank's initial expenses, it is likely that a reduction in the costs associated with litigation over misrepresentations will balance out such initial expenses.

Not only would the sperm clinic be able to eliminate the incentives for sperm donors to misrepresent or withhold information, it would also be able to impose serious consequences on sperm donors who provide inaccurate or incomplete information at the time of donation. The *Johnson* decision enables the A.I.D. family to gain access to the sperm donor identity and medical records. The sperm bank, as the opposing party to the litigation, would also gain access to donor information. Therefore, sperm banks would be afforded the opportunity to hold its donors liable for such misrepresentations. Thus, the *Johnson* court's decision would enable sperm banks to hold its sperm donors accountable for the conveyance of false medical information.

However, it is important to emphasize that the ultimate responsibility of genetic screening lies with the sperm banks. Mere reliance on donor questionnaires is an unreasonable and inadequate screening method. Thus, regardless of the extent to which a donor reveals his medical history, the duty to thoroughly screen each donation must remain fully upon the sperm bank.<sup>176</sup> A sperm donor may disclose the medical history to the fullest extent possible, yet be unaware that he is carrying a defect or disease.<sup>177</sup> Therefore, the clinic has a duty to ask questions that effectively prompt complete disclosure of a donor's medical history to test sperm for diseases beyond that which the donor indicates might be applicable.<sup>178</sup>

By granting access to sperm bank records regarding donors, the *Johnson* court has given participants of A.I.D. the means necessary to hold sperm banks accountable for their misrepresentations or negligent screening procedures. Consequently, sperm clinics are forced to place more emphasis on their genetic testing and screening procedures and to represent the health of the sperm more accurately in order to avoid the threat of litigation. Such improvements in the screening and testing procedures of sperm banks will most likely decrease the number of A.I.D. children born with genetic diseases or defects.

### CONCLUSION

The law surrounding A.I.D. is in its early phases of development; however,

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176. See *id.* at 527.

177. A study of A.I.D. screening practices revealed that ninety percent of the sperm donors failed to identify genetic defects in their family history, and even sperm donors with medical training failed to report over two-thirds of their family disorders. See *id.* at 527 n.26 (citing M. Chrystie Timmons et al., *Genetic Screening of Donors for Artificial Insemination*, 35 FERTILITY & STERILITY 451, 453, 455 (1991)).

178. See McIntyre, *supra* note 17, at 545 ("it is more practical to place the burden of detecting genetic defects on the AID practitioner than on donors who are likely to be unfamiliar with the intricacies of genetics").

the *Johnson* court sets precedent in addressing legal issues of first impression for the area of donor anonymity. Unfortunately, *Johnson* has the effect of abolishing the guarantee of sperm donor anonymity, which may jeopardize the ability of A.I.D. recipients to use the procedure to conceive and raise a family free from donor and state intrusion. Additionally, as a result of finding that a donor possesses merely a limited right to privacy, sperm banks may be forced to deal with a reduction in the number of men willing to donate.

However, the *Johnson* decision has provided A.I.D. participants with the means necessary to successfully bring suit against a sperm clinic and hold it accountable for misrepresentations. This increased accountability may lead to improved genetic screening standards and, therefore, less A.I.D. children born with genetic disorders.

Although the effects of the *Johnson* ruling are likely to be far reaching, the *Johnson* decision, and others like it, are necessary to develop the law of A.I.D. Although the *Johnson* decision went too far in limiting a sperm donor's right to remain anonymous, clarifying the issues involved in A.I.D. will allow individuals to make more informed decisions about whether to donate their sperm and permit families to make more informed decisions about whether or not to conceive a child using this rapidly increasing assisted reproductive technology.



# NONPHYSICAL PERSONAL INJURY SETTLEMENTS AND JUDGMENTS: AMENDING THE INTERNAL REVENUE CODE TO EXCLUDE ATTORNEY FEES

PAUL M. JONES, JR.\*

## INTRODUCTION

The U.S. Tax Court recently announced in *Kenseth v. Commissioner*,<sup>1</sup> that “Congress, not the Courts, is the final arbiter of how the tax burden is to be borne by taxpayers.”<sup>2</sup> Regardless of whether Congress, the Courts, or even the Internal Revenue Service ultimately holds the final responsibility for the allocation of tax burdens, a crucial shift is taking place with respect to the federal income tax treatment of attorney fees awarded in nonphysical personal injury settlements and judgments.

A real life example illustrates the harsh result of this shift. Don Lyons filed a Title VII sex discrimination complaint against his employer for retaliation. Lyons ultimately prevailed in the case and received a judgment of \$15,000 in punitive damages.<sup>3</sup> Because punitive damages are taxable<sup>4</sup> Lyons owed \$5467 in income tax on the award.<sup>5</sup> Lyons received a net award of \$9533.<sup>6</sup> Lyons’ attorney petitioned the court for \$170,000 in legal fees.<sup>7</sup> If the court awarded only \$150,000 in attorney fees to Lyons as part of his judgment, Lyons would owe \$67,791 in tax on the attorney fee award, as if it were included in his gross income.<sup>8</sup> Thus, Lyons’ award is devoured by taxes and he would actually pay the government \$58,236 for prevailing in a legitimate sex discrimination case against his employer.<sup>9</sup> In short, because legal fees often constitute a significant portion of any civil settlement or judgment,<sup>10</sup> a plaintiff who brings a civil action for

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1. 114 T.C. 399 (2000), *aff’d*, 259 F.3d 881 (7th Cir. 2001).

2. *Id.* at 415.

3. 146 CONG. REC. S7160-03, \*S7162-64 (2000) (statement of Sen. Grassley) (discussing a letter sent by an attorney representing Lyons regarding the current dilemma created by the federal tax laws).

4. *See, e.g.*, *Stevan v. Comm’r*, 80 T.C.M. (CCH) 420 (2000) (holding that punitive damages are included in gross income and subject to federal income tax).

5. 146 CONG. REC. S7160-03, \*S7163 (2000).

6. *Id.*

7. *Id.* at \*S7164.

8. *Id.*

9. *Id.*

10. Whether a plaintiff pays his lawyer by the hour, by a fixed fee, or under a contingent fee arrangement, attorney fees are likely to be substantial. The most common type of fee arrangement for plaintiffs in civil litigation is the contingent fee. *See* Bruce L. Hay, *Contingent Fees and Agency Costs*, 25 J. LEGAL STUD. 503 (1996). “Contingency fees usually are calculated as a percentage of the amount recovered. Typically, contingency fees range between twenty-five and fifty percent,

nonphysical personal injuries must consider whether legal fees included in any settlement or judgment award can be excluded from his gross income.<sup>11</sup>

Section 104(a)(2) of the Internal Revenue Code of 1986, as amended (the "Code"), allows a taxpayer to exclude from gross income "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness."<sup>12</sup> Thus, attorney fees, included in a plaintiff's settlement or judgment award for physical injuries, are excluded from the plaintiff's gross income and therefore are not subject to federal personal income taxation.<sup>13</sup> However, attorney fees included in a damage award for nonphysical injury (e.g., employment discrimination, sex discrimination, personal injury, breach of contract, and wrongful termination) are not necessarily excluded from the plaintiff's gross income and thus may be subject to federal personal income taxation. Moreover, there is no code section specifically allowing a deduction for legal fees, while Code sections 162 and 212 do allow the deduction of fees as business expenses or as production of income, respectfully.<sup>14</sup>

Currently, the federal circuit courts do not concur as to whether attorney fees (or interest thereon), which are included as part of a plaintiff's damages in a settlement or judgment for nonphysical injury, can be excluded from his gross income for federal income tax purposes. In light of this conflict, U.S. Tax Court decisions have varied widely, guided largely by the circuit to which an appeal from its decision would lie.

Plaintiffs who stand to receive damage awards through settlements or judgments should not be subject to the ambiguity and unpredictability of such a fundamental tax consequence created by the current conflict. The Internal Revenue Service's (the "Service") position has been consistent—attorney fees paid in an award are gross income to the plaintiff under the "fruit of the tree" doctrine.<sup>15</sup> Under this doctrine, the taxpayer who "earns" or "derives" the

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with the higher percentages awarded if the case progresses beyond the trial stage, and the lower percentages awarded if the case is settled before trial." Drew C. Phillips, *Billing Issue: Contingency Fees: Rules and Ethical Guidelines*, 11 GEO. J. LEGAL ETHICS 233, 233-34 (1998).

11. For purposes of consistency and neutrality, the male pronoun is used generically throughout to refer to plaintiff, and the female pronoun is used throughout to refer to plaintiff's attorney.

12. I.R.C. § 104(a)(2) (1994 & Supp. V 1999).

13. See, e.g., Priv. Ltr. Rul. 99-52-080 (Sept. 30, 1999) (holding that damages awarded in connection with a logging accident that caused plaintiff-taxpayer a "crushing, life-threatening injury resulting in the separation of three pelvic bones" were excludable from taxpayer's gross income).

14. I.R.C. §§ 162, 212 (1994 & Supp. V 1999).

15. In fact, the Service recently released a Market Segment Specialization Program audit guide that contains examination techniques for settlements and judgments.

In cases involving contingent fee arrangements, the gross award/settlement, without diminution for attorneys' fees or costs, should be included in the taxpayer's income.

This treatment is in accord with IRC section 61 and the long established principle, "the



income is the taxpayer who will be taxed on that income. For plaintiffs who receive damage awards, this means that a significant portion of their recovery may be paid out in taxes on income that they never “actually” receive.

Courts in the Fifth,<sup>16</sup> Sixth,<sup>17</sup> and Eleventh<sup>18</sup> Circuits have held that attorney fees included in a plaintiff’s damage award may be excluded from the plaintiff’s gross income for federal income tax purposes. These courts explain that attorney fees are excludable from a plaintiff’s gross income, in part, because the state law in those jurisdictions grants attorneys lien rights (or ownership rights) to income resulting from a settlement or judgment award. Thus, those courts have held that since the attorney had a “right” to the income, the plaintiff may exclude that portion of his award from his gross income. However, it is not clear that the state law is always dispositive in these cases.

Conversely, courts in the First,<sup>19</sup> Ninth,<sup>20</sup> and Federal<sup>21</sup> Circuits have held that attorney fees included in a plaintiff’s damage award should be included in the plaintiff’s gross income (though potentially deductible, depending on the plaintiff’s circumstances). These circuit courts explain that the income cannot be excluded from the plaintiff’s gross income because the plaintiff has “earned” that income and cannot assign it to someone else and avoid taxation.

Part I of this Note will identify the roots of this conflict by discussing the treatment of civil damage awards in the Code. Additionally, it will discuss and analyze the conflicting cases and recent U.S. Tax Court opinions that have applied the federal circuit holdings. Part II will set forth the reasons why the current circuit split must be resolved and discuss a number of possible resolutions to the conflict. Part III will posit that Congress should act immediately to amend Code section 104 to provide an additional exclusion for the settlement or judgment amounts plaintiffs receive due to nonphysical personal injury, which are attributable or attributed to attorney fees paid to facilitate the taxpayer’s lawsuit.

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fruit of the tree” theory, that income is taxable to the person who earns it and cannot be assigned to someone else. . . . Examiners handling cases involving payments of attorneys’ fees in lawsuits in Alabama, Michigan, and Texas, however, should be aware that there is contrary authority based on an interpretation of applicable state law. . . . Until the issue is resolved, the Action on Decision in *Cotnam* [, which states that the Service will not follow the contrary authority,] should be followed and taxpayers should not be allowed to net the proceeds of the direct payment of attorneys’ fees in all cases arising under any law other than Alabama, Michigan, and Texas.

INTERNAL REVENUE SERVICE, DEP’T OF THE TREASURY, MARKET SEGMENT SPECIALIZATION PROGRAM (2001).

16. See *Cotnam v. Comm’r*, 263 F.2d 119, 125 (5th Cir. 1959).

17. See *Estate of Clarks v. United States*, 202 F.3d 854, 858 (6th Cir. 2000).

18. See *Davis v. Comm’r*, 210 F.3d 1346, 1347 (11th Cir. 2000).

19. See *Alexander v. Comm’r*, 72 F.3d 938, 944 (1st Cir. 1995).

20. See *Coady v. Comm’r*, 213 F.3d 1187, 1191 (9th Cir. 2000), *cert. denied*, 121 S. Ct. 1604 (2001).

21. See *Baylin v. United States*, 43 F.3d 1451, 1455 (Fed. Cir. 1995).

# I. THE CODE'S TREATMENT OF DAMAGE AWARDS AND THE CONFLICT AMONG THE FEDERAL CIRCUITS

The Code imposes a tax on an individual's taxable income.<sup>22</sup> Taxable income consists of a taxpayer's adjusted gross income ("AGI") minus either the taxpayer's standard deduction or the sum of the taxpayer's itemized deductions ("below the line" deductions).<sup>23</sup> AGI is derived from the taxpayer's gross income less the deductions allowed under Code section 62 ("above the line" deductions).<sup>24</sup> Gross income "means all income from whatever source derived."<sup>25</sup> Code sections 101 through 137 describe items specifically excluded from gross income.<sup>26</sup> Currently, Code section 104(a)(2) allows a taxpayer to exclude from gross income damages received on account of personal physical injuries or physical sickness.<sup>27</sup>

Prior to 1992, courts interpreted Code section 104 to exclude damages from both physical and nonphysical injury to a person because the language of the statute did not distinguish between the two.<sup>28</sup> However, in *United States v. Burke*<sup>29</sup> and *Commissioner v. Schleier*,<sup>30</sup> the U.S. Supreme Court ruled that lost earnings damages resulting from employment discrimination were not excludable. In 1996, Congress amended Code section 104 to exclude from gross income only damages received "on account of personal physical injuries or physical sickness."<sup>31</sup> Thus, damages arising from all nonphysical injury cases are not generally excluded from the plaintiff's gross income.<sup>32</sup>

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22. I.R.C. § 1 (1994 & Supp. V 1999).

23. *Id.* § 63.

24. *Id.* § 62. The expressions "below the line" and "above the line" are used by tax practitioners to refer to the deductions taken in arriving at AGI (i.e., above the line deductions) and those deductions taken in arriving at taxable income (i.e., below the line deductions). The "line" refers to Line 33 on Form 1040, U.S. Individual Income Tax Return.

25. *Id.* § 61 (1994).

26. *Id.* §§ 101-37 (1994 & Supp. V 1999).

27. *Id.* § 104(a)(2).

28. See generally Laura Sager & Stephen Cohen, *Discrimination Against Damages for Unlawful Discrimination: The Supreme Court, Congress, and the Income Tax*, 35 HARV. J. ON LEGIS. 447, 452-73 (1998) (arguing that attorney fees awarded in civil rights cases should be fully deductible or excluded from gross income). The original Code section 104(a)(2) excluded from gross income "damages . . . received . . . on account of personal injuries or sickness." I.R.C. § 104(a)(2) (1994 & Supp. V 1999). The exclusion was added to the Code in 1918. See ALAN GUNN & LARRY D. WARD, CASES, TEXT AND PROBLEMS ON FEDERAL INCOME TAXATION 146 (3d ed. 1995).

29. 504 U.S. 229 (1992).

30. 515 U.S. 323 (1995).

31. I.R.C. § 104 (1994 & Supp. V 1999). Congress enacted the amendment as part of the Small Business Jobs Protection Act of 1996. *Id.*

32. See Laura Sager & Stephen Cohen, *How the Income Tax Undermines Civil Rights Law*,



Given that damages for nonphysical injuries are now taxable, determining how to treat legal fees in such cases is particularly important.<sup>33</sup> However, a conflict exists among the federal circuits as to whether attorney fees awarded in settlements or judgments for nonphysical injury can be excluded from gross income for federal income tax purposes.<sup>34</sup> Although attorney fees are not expressly excluded from gross income in the Code, some courts have held that attorney fees awarded in a settlement or judgment should not be included in a plaintiff taxpayer's gross income.<sup>35</sup> Other courts have applied the assignment of income doctrine<sup>36</sup> and held that plaintiffs cannot assign to their attorneys the portion of their recoveries awarded as attorney fees.<sup>37</sup> Although those courts allowed plaintiffs to deduct such legal fees as a miscellaneous itemized deduction, the result in too many cases is still less than fair, as illustrated by the result in Lyons' case.

#### *A. Cases Where Courts Have Allowed Plaintiff to Exclude Legal Fees*

Some federal circuits have allowed nonphysical injury plaintiffs to exclude attorney fees awarded in settlements or judgments from their gross income. In *Cotnam v. Commissioner*,<sup>38</sup> the Fifth Circuit held that the plaintiff's attorney fee award was not gross income because Alabama law granted the plaintiff's

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73 S. CAL. L. REV. 1075, 1079 (2000).

33. *Id.* Incidentally, at least one estimate places the additional revenue raised by the 1996 amendment Code section 104 at \$230 million. Marcia Coyle, *U.S. Tax on Damages Under Fire*, NAT'L L.J., Aug. 9, 1999, at A1.

34. See generally ROBERT W. WOOD, TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENTS (2d ed. 1998); K. SPRIGGS, 1 REPRESENTING PLAINTIFFS IN TITLE VII ACTIONS, § 1.03 (2d. ed. 1998); Sheldon I. Banoff & Richard M. Lipton, *Whipsaw on Settlement Lawsuits: New Hope?*, 92 J. TAX'N 190 (2000); Susan Kalinka, *A.L. Clarks Est. and the Taxation of Contingent Fees Paid to an Attorney*, 78 TAXES 16 (2000); John H. Skarbnik, *New Tax Planning Needed for Employment-Related Damages*, 26 TAX'N FOR LAW. 39 (1997); William Winslow, *Tax Hell in Nonphysical Torts*, TRIAL, May 1999; Robert W. Wood, *The Plight of the Plaintiff: The Tax Treatment of Legal Fees*, TAX NOTES, at Nov. 16, 1998, 98 TNT 220-101; Jared A. Khokhar, *Tax Aspects of Settlements & Judgments*, 522-2d Tax Mgmt. (BNA) (2000).

35. *Davis v. Comm'r*, 210 F.3d 1346 (11th Cir. 2000); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959).

36. The assignment of income doctrine also known as the "fruit of the tree" doctrine was established in *Lucas v. Earl*, 281 U.S. 111, 115 (1930) (holding that the income tax is imposed on the income of those who earned it and thus, "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.") (emphasis added); see also *Helvering v. Horst*, 311 U.S. 112 (1940).

37. *Coady v. Comm'r*, 213 F.3d 1187 (9th Cir. 2000), cert. denied, 121 S. Ct. 1604 (2001); *Alexander v. Comm'r*, 72 F.3d 938 (1st Cir. 1995); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995).

38. 263 F.2d at 125.

attorneys a right to the fees.<sup>39</sup> Alabama Code provides that "attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them."<sup>40</sup> The existence of the Alabama attorney lien statute led the *Cotnam* court to conclude that Cotnam never had rights to amounts subsequently paid to her attorneys. Rather, the attorneys were the sole owners of that right to income throughout the lawsuit.<sup>41</sup>

In *Estate of Clarks v. United States*,<sup>42</sup> the Sixth Circuit was presented with the question of whether Clarks' gross income included the full interest award or whether he could exclude from his gross income the portion paid to his attorney. Clarks' attorneys were paid pursuant to a contingency fee agreement initiated prior to the lawsuit, but the court allowed him to exclude from his gross income the portion of post-judgment interest that was paid to his attorneys.<sup>43</sup> The court reasoned that the assignment of income doctrine did not apply.<sup>44</sup> Rather, the court followed the rule applied in *Cotnam* and held that the Michigan attorney lien law was similar to Alabama's.<sup>45</sup>

Similarly, the Eleventh Circuit dutifully followed *Cotnam* by allowing the plaintiff in *Davis v. Commissioner*<sup>46</sup> to exclude a portion of the punitive damage award that was paid to the plaintiff's attorneys under a contingency fee arrangement.<sup>47</sup> Although the court reached a verdict favorable to the plaintiff, it acknowledged that it was bound by *Cotnam* because it was required to adopt as binding precedent all the decisions of the former Fifth Circuit that were made prior to September 30, 1981.<sup>48</sup>

The case of *Foster v. United States* presented an analogous situation.<sup>49</sup>

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39. *Id.*

40. *Id.* (citing ALA. CODE § 46-64 (1940)).

41. *Id.*

42. 202 F.3d 854 (6th Cir. 2000).

43. *Id.* at 857-58.

44. *Id.*

45. *Id.* at 856. In Michigan, the law regarding attorney liens is not statutory but exists under common law. *Estate of Clarks v. United States*, 98-2 U.S. Tax Cas. (CCH) ¶ 50,868 (E.D. Mich. 1998) (citing *George v. Gelman*, 506 N.W.2d 583, 585 (Mich. 1993)). Nevertheless, the Sixth Circuit found that the common law attorney lien in *Estate of Clarks* operated in more or less the same way as the Alabama lien law in *Cotnam*. *Estate of Clarks*, 202 F.3d at 856.

46. 210 F.3d 1346 (11th Cir. 2000).

47. *Id.* at 1348.

48. Fifth Circuit cases decided prior to September 30, 1981, can only be overruled by an en banc court. *Id.* at 1347 n.4.

49. *Foster v. United States*, 106 F. Supp. 2d 1234, 1239 (N.D. Ala. 2000), *aff'd in part, rev'd in part*, 249 F. 3d 1275 (11th Cir. 2001); *see also* *Srivastava v. Comm'r*, 220 F.3d 353, 364-65 (5th Cir. 2000) (holding that a portion of the settlement award payable to taxpayer's attorneys under a contingent fee arrangement was not included in taxpayer's gross income because the court was bound by *Cotnam*), *reh'g denied* (Sept. 19, 2000); *Griffin v. Comm'r*, 81 T.C.M. (CCH) 972 (2001) (following *Cotnam* and holding that a portion of the settlement award payable to taxpayer's



There, the U.S. district court in Alabama followed *Cotnam*, and stated that until the court of appeals or Supreme Court ruled otherwise, *Cotnam* controlled its decision. Nonetheless, the court noted that “there are serious and legitimate questions” as to whether the decision should be followed and “[s]trong arguments can be made . . . that *Cotnam* is not consonant with Supreme Court decisions like *Horst* . . . .”<sup>50</sup> Despite the *Foster* court’s rhetoric, nonphysical injury plaintiffs whose claims arise in the Fifth, Sixth, and Eleventh Circuits can exercise some confidence that attorney fees awarded in their settlements or judgments may be excluded from their gross income.<sup>51</sup> Yet, since neither the U.S. Supreme Court nor Congress has resolved the issue, such plaintiff taxpayers must weigh the risk carefully and should be advised by their attorneys that the tax outcome is by no means certain.

### *B. Cases Where Attorney Fees are Included, but Deductible*

A number of courts have held that under the assignment of income doctrine,<sup>52</sup> a plaintiff cannot assign the attorney fee portion of a settlement or judgment award and subsequently exclude that amount from his gross income. These cases allow the plaintiff to deduct the amount paid in legal fees in arriving at taxable income.<sup>53</sup> Nonetheless, these deductions are subject to the two percent floor rule for miscellaneous itemized deductions.<sup>54</sup> Furthermore, the amount deducted, if over a certain amount, will be subject to the alternative minimum tax (the “AMT”), under which the itemized deductions are not allowed.<sup>55</sup> This was a serious problem for the AMT taxpayer because it effectively prevents the taxpayer from being able to escape paying taxes on an amount he never received.<sup>56</sup> Despite the potential for unfair results in nonphysical personal injury

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attorneys under a contingent fee arrangement should be excluded from taxpayer’s gross income under the assignment of income doctrine).

50. *Foster*, 106 F. Supp. 2d at 1239. In *Helvering v. Horst*, the court, applying the “fruit of the tree” doctrine, held that a taxpayer, who gifted negotiable interest coupons to his son before the coupon due dates, could not avoid income tax on such interest because the person who earns the income must be taxed upon it. 311 U.S. 112, 120 (1940).

51. See Timothy R. Koski, *Contingent Fee Paid to Attorney Can Be Income to Client*, 65 PRAC. TAX STRAT. 166, 169 (2000) (stating that plaintiffs “in the Fifth, Sixth, and Eleventh Circuits have the best chance of success” with regard to Service scrutiny); see also Banoff & Lipton, *supra* note 34, at 191 (stating that *Estate of Clarks* “provides authority (at least for taxpayers not located in the First or Federal Circuits) for purposes of avoiding potential penalties” under Code sections 6662 and 6694 [the article was issued prior to the Ninth Circuit decisions that followed the First and Federal Circuit]).

52. See *supra* note 36.

53. See I.R.C. § 162 (1994 & Supp. V 1999) (deduction for business expenses); *id.* § 212 (deductions for expenses in producing income).

54. *Id.* § 67 (1994).

55. *Id.* § 55 (1994 & Supp. V 1999).

56. *Id.* § 68. The floor is adjusted annually, if necessary, for inflation. In 1999, the threshold

cases, courts have sided with the Service and held that plaintiff taxpayers cannot exclude the amounts paid out in legal fees to obtain their settlements or judgments in such cases.

In *Alexander v. Internal Revenue Service*,<sup>57</sup> the First Circuit decided a case in which a plaintiff did not attempt to exclude legal fees, but rather deducted the fees in arriving at what the plaintiff characterized as capital gain income from the settlement.<sup>58</sup> The court held that the portion of damages from plaintiff's breach of contract settlement that were expended for attorney fees could not be properly subtracted in arriving at capital gain because the claim resulted in ordinary income to the plaintiff.<sup>59</sup> More important, the court held that the plaintiff's legal fees did not qualify as a reimbursed employee business expense.<sup>60</sup> Thus, the plaintiff was forced to take the deduction below the line, and be subjected to the two percent miscellaneous itemized deduction floor.

Similarly, in *Baylin v. United States*,<sup>61</sup> the Federal Circuit ruled that a portion of the plaintiff's condemnation award paid to attorneys should be included in the taxpayer's gross income despite plaintiff's lack of actual possession of the proceeds.<sup>62</sup> In *Fredrickson v. Commissioner*,<sup>63</sup> the Ninth Circuit in an unpublished opinion, held that a portion of the plaintiff's sex discrimination settlement damages paid to her attorneys could not be treated as a reimbursed employee business expense.<sup>64</sup> Despite the fee-shifting provisions in Title VII that force defendants to pay a prevailing plaintiff's attorney fees, the plaintiff in *Fredrickson* was forced to pay tax on amounts received by his attorneys.<sup>65</sup> A number of U.S. Tax Court cases have followed these cases, usually noting that the attorney lien statutes cited in their controversies differ from the Alabama

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was \$126,600. See Rev. Proc. 98-61, 1998-52 I.R.B. 18. One interesting application of the AMT involves the tax treatment of former President Clinton's legal defense fund which, if included in his gross income, would leave \$2.25 million subject to AMT. See Lee A. Sheppard, *News Analysis—A Look at the Clinton and Gore Tax Returns*, 87 TAX NOTES 472 (2000).

57. See *Alexander v. Comm'r*, 72 F.3d 938 (1st Cir. 1995).

58. *Id.* at 940-41.

59. *Id.* at 944.

60. *Id.* at 946. Plaintiff sought to characterize the legal fees as reimbursed employee business expenses to obtain an "above the line" deduction, which would allow the plaintiff to deduct the entire amount and avoid paying tax on the taxable amount of two percent if characterized as a miscellaneous itemized deduction (i.e., a "below the line" deduction). The court determined that the legal fees were "properly deducted 'below the line.'" *Id.*

61. 43 F.3d 1451 (Fed. Cir. 1995).

62. *Id.* at 1455.

63. 166 F.3d 342, 1998 U.S. App. LEXIS 31964 (9th Cir. Dec. 21, 1998).

64. *Id.* at \*3.

65. *Id.*; see also *Coady v. Comm'r*, 213 F.3d 1187, 1190-91 (9th Cir. 2000) (holding that under Alaska law, a portion of damage award used to pay attorney fees, although deductible as a miscellaneous itemized deduction, was included in taxpayers' gross income), *cert. denied*, 121 S. Ct. 1604 (2001).



statute.<sup>66</sup>

One recent U.S. Tax Court decision, *Kenseth v. Commissioner*,<sup>67</sup> addresses the controversy over whether attorney fee awards in nonphysical personal injury settlements and judgments should be excluded from gross income. *Kenseth* was decided by a divided court, further highlighting the larger circuit conflict by showing that not only are the federal circuits at odds, but the judges of the tax court are as well.<sup>68</sup> The *Kenseth* majority held that a portion of a plaintiff taxpayer's settlement award used to pay attorney fees under a contingent fee arrangement must be included in his gross income.<sup>69</sup> According to the court, *Kenseth* and other plaintiffs could deduct legal fees as a miscellaneous itemized deduction.<sup>70</sup> However, the court's majority, applying the "fruit of the tree" doctrine, refused to allow a full deduction or exclusion.<sup>71</sup> This continuing conflict among the federal circuits and within the tax court is disparaging for taxpayers who suffer from nonphysical personal injuries. Such taxpayers not only incur potential reductions in their recovery, but also are forced to have their claims litigated in an environment where the tax consequences to the plaintiff-taxpayer are unpredictable. This conflict requires immediate resolution. Doing so will increase recovery for nonphysically injured plaintiffs, and alleviate uncertainty in the calculation of plaintiff's income, while encouraging predictability and consistency in tax court decisions.

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66. See, e.g., *Kenseth v. Comm'r*, 114 T.C. 26, 36 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001); *Hukkanen-Campbell v. Comm'r*, 79 T.C.M. (CCH) 2122, \*15 (2000) (distinguishing a Missouri statute to find that a portion of the damage award used to pay attorney fees, although deductible as a miscellaneous itemized deduction, was included in taxpayers' gross income); *Benci-Woodward v. Comm'r*, 76 T.C.M. (CCH) 787, 790 (1998) (distinguishing a California statute to find that a portion of the settlement award used to pay attorney fees, although deductible as a miscellaneous itemized deduction, was included in taxpayers' gross income); *Sinyard v. Comm'r*, 76 T.C.M. (CCH) 654, 658 (1998) (distinguishing an Arizona statute to find that a portion of the settlement award used to pay attorney fees, although deductible as a miscellaneous itemized deduction, was included in taxpayers' gross income); *Estate of Gadlow v. Comm'r*, 50 T.C. 975 (1968) (distinguishing Pennsylvania and Alabama statutes); *Petersen v. Comm'r*, 38 T.C. 137 (1962) (distinguishing Nebraska and South Dakota statutes). But see *Kenseth*, 114 T.C. at 38 (Beghe, J., dissenting) (finding that the majority courts' use of "narrow" state law analysis was flawed and "broader" consideration of whether plaintiff has substantial control over the attorney fee income should be dispositive); *O'Brien v. Comm'r*, 38 T.C. 707 (1962) (noting in dictum that state law was not dispositive).

67. *Kenseth*, 114 T.C. at 26.

68. *Id.* at 38.

69. *Id.* at 29.

70. See *id.* at 38.

71. *Id.* at 34.

## II. RATIONALE FOR RESOLVING THE ISSUE AND SUGGESTED RESOLUTIONS

### *A. Rationale for Resolving the Issue*

The present conflict in the federal circuit courts over whether a nonphysical personal injury plaintiff can exclude the portion of his award attributable to legal fees should be resolved immediately. The conflict could be resolved by eliminating the miscellaneous itemized deduction effect and the AMT result (i.e., by allowing legal fees in nonphysical personal injury settlements and judgments to be fully deductible or excludable). However, one must initially examine why the conflict should be resolved.

A solution is needed for a variety of reasons. First, the AMT consequences to plaintiffs were unforeseen and unintended by Congress and thereby create an unjust result. Moreover, even if AMT were not problematic, forcing plaintiffs to deduct the attorney fees subject to the two percent miscellaneous itemized deduction floor still produces an unjust result.<sup>72</sup> Second, full deductibility or exclusion would promote accuracy and fairness for the plaintiff in nonphysical personal injury cases.<sup>73</sup> Third, full deductibility or exclusion would promote consistency and predictability for nonphysical personal injury plaintiffs and their attorneys. Fourth, full deductibility or exclusion would preserve the fee-shifting provisions of federal anti-discrimination laws.<sup>74</sup> Finally, adopting a solution would put an end to the incessant litigation generated by the current conflict.

*1. The Code's AMT and Miscellaneous Itemized Deduction Provisions.*—The AMT and miscellaneous itemized deduction consequences to nonphysical personal injury plaintiffs were unforeseen and unintended by Congress and thereby, create an unjust result to plaintiffs with an income in excess of \$128,950 (including damage awards from settlements or judgments).<sup>75</sup> One commentator, who has written about the inequities created by the current federal circuit conflict, provides the following illustration:

[A]ssume that a plaintiff, . . . John, sues his employer for claims arising under state law as well as the Federal Age Discrimination in Employment Act. John enters into a settlement agreement this year for \$1 million, and the award is deposited in a trust account of John's attorney, Anne. Assume that 60 percent, or \$600,000, of the award is paid to John from the account in 2000, and the remaining \$400,000 is paid to Anne under a contingent-fee contract entered into between Anne

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72. Deborah A. Geier, *Some Meandering Thoughts on Plaintiffs and Their Attorneys' Fees and Costs*, 87 TAX NOTES 531 (2000) (arguing that Congress should amend the Code immediately so that attorney fees directly connected to an included settlement or litigation recovery are deductible "above the line").

73. Sager & Cohen, *supra* note 32, at 1104.

74. *Id.*

75. Rev. Proc 99-42, 1999-46 I.R.B. 568. The original amount at which the AMT was triggered was \$100,000 but is indexed for inflation annually. *Id.*



and John before the initiation of the litigation.<sup>76</sup>

Under this scenario, if John must include the full \$1 million in his gross income, John had to resort to a deduction to avoid taxation on the \$400,000 paid to his attorney. Code sections 162 or 212 allow John to make such a deduction. However, these deductions, allowed under Code section 67, are considered miscellaneous itemized deductions.<sup>77</sup> That is, the deduction is taken below the line and subject to a two percent floor up to which the income will at least be taxed.

This categorization has two consequences for John under the regular tax system and will very likely trigger the AMT. First, under the regular tax system, John's \$400,000 is deductible only to the extent that it, along with his other miscellaneous itemized deductions within the meaning of section 67, exceeds two percent of his adjusted gross income. Therefore, a rather modest portion of the fees, equal to two percent (or \$20,000), becomes immediately nondeductible (if we assume, for the sake of simplicity, that this is John's only miscellaneous itemized deduction). Second, because John's adjusted gross income would clearly exceed \$128,950 in 2000 because of the award, his itemized deductions, including his deduction for attorneys' fees, will be reduced under section 68 by up to a whopping eighty percent under the regular tax system.<sup>78</sup>

Thus, the miscellaneous itemized deduction rules force John to forfeit a significant amount of his recovery to pay taxes on income that was transferred immediately to his attorney. Not only did John not enjoy the benefits of the \$400,000, but his \$600,000 recovery will be further reduced because of the miscellaneous itemized deduction rules. Moreover, the AMT takes an even deeper cut out of John's recovery.

[T]he biggest consequence for people like John is not under the regular tax system but rather under the [AMT] system. Under the [AMT], section 68 is ignored (good news), but all allowable miscellaneous itemized deductions, including the \$ 380,000 on our assumed facts that remains deductible after applying section 67 only, must be added back to his tax base under the [AMT] (bad news). In other words, taxpayers with significant miscellaneous itemized deductions will see some of them become nondeductible under the regular tax system and, worse yet, will usually trigger the [AMT], under which no miscellaneous itemized deductions are allowable. Under the [AMT], in short, John can deduct none of his \$ 400,000 in attorneys' fees. Even though the marginal tax rate that applies to his tax base under the [AMT] is lower than would apply under the regular tax system, John is worse off because of the inability to deduct his \$ 400,000 attorney fee.<sup>79</sup>

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76. Geier, *supra* note 72, at 533.

77. I.R.C. § 67 (1994).

78. *Id.*

79. Geier, *supra* note 72, at 533 (footnotes omitted).

Thus, the AMT reduces John's recovery even further and, under a regime where John must include his entire recovery in his gross income, John pays an inordinate amount of income tax based on the inclusion of amounts received by his attorney, but not by him.

The loss to hypothetical John was not likely intended by Congress when it enacted the AMT<sup>80</sup> and certainly not when it authorized the fee-shifting provisions in the civil rights laws that allow plaintiffs to recover attorney fees in such civil rights claims.<sup>81</sup> Congress enacted the AMT to "ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits."<sup>82</sup> However, "discrimination plaintiffs are often penalized through operation of the AMT even though their 'substantial economic income' is the result of a one-time settlement or judgment, and only occurs because of the effects of obtaining a remedy for discrimination."<sup>83</sup>

The rationale behind the AMT is simply inapplicable to plaintiffs seeking redress for wrongful discrimination committed by employers, lenders, or others because such plaintiffs are already forced to pay tax on their portion of recovery in a settlement or judgment. Under current law that does not allow nonphysical injury plaintiffs to exclude damages received for being wronged, a nonphysical injury plaintiff *does* incur a significant tax liability and *is not* permitted to avoid it by *exclusion*. Moreover, under current law, the plaintiff is unable to fully *use a deduction* given the constraints of Code section 67 and the AMT. Such results appear to be unintended by Congress because as enacted, the result depletes the awards to civil rights plaintiffs. Thus, the result should be avoided by making the attorney fees in such cases fully deductible or excludable from a nonphysical personal injury plaintiff's gross income.

2. *Promoting Accuracy and Fairness to Nonphysical Injury Plaintiffs.*—Full deductibility or exclusion would promote accuracy and fairness for the plaintiff in nonphysical personal injury cases.<sup>84</sup> Though the U.S. Tax Court in *Kenseth* declined to address tax policy considerations, leaving such authority to Congress, the court's majority, which disallowed exclusion of plaintiff's attorney fees, agreed that current legislation may result in "anomalous or inequitable results

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80. STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 432 (Comm. Print 1987).

81. See discussion *infra* Part II.A.4.

82. See STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., *supra* note 80.

83. Brief of Amici Curiae Nat'l Employment Lawyers Ass'n et al., *Sinyard v. Comm'r*, 76 T.C.M. (CCH) 654 (1998); see also *Kenseth v. Comm'r*, 114 T.C. 399, 432 (2000) (Beghe, J., dissenting) (discussing that given the possibility that under the AMT a plaintiff could pay more in tax than he receives, Congress certainly did not expect or intend "that the interplay of the newly enacted itemized deduction and AMT provisions could result in effective rates of tax substantially exceeding 50 percent up to more than 100 percent of a net recovery"), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

84. Sager & Cohen, *supra* note 32, at 1104.



with respect to particular taxpayers.”<sup>85</sup> Current tax law does render inequitable results with respect to nonphysical injury plaintiff-taxpayers who receive settlements or judgments and are forced to pay income tax on legal fees incurred to pursue their claims. “A full deduction or exclusion would provide a more accurate measure of the plaintiff’s income.”<sup>86</sup> Increasing the accuracy with which the plaintiff’s taxable income is determined achieves a basic goal of the tax law—taxpayers should pay no more or less than imposed by the Code.

3. *Promoting Consistency and Predictability of Tax Consequences.*—With respect to the tax treatment of attorney fees awarded in nonphysical injury settlements and judgments, greater consistency and predictability is needed on two levels: the tax treatment of such income should be consistent among the federal circuits, and the tax treatment of such income should be consistent despite differences in state attorney lien statutes.

First, full deductibility or exclusion of such attorney fees is needed to promote consistency and predictability among the federal circuits. Currently, plaintiffs and their attorneys are forced to wade through the muddled case law, where the facts in the reported cases are confusing and the analysis often takes anarchic turns.<sup>87</sup> The federal circuit split results in a landscape where nonphysical personal injury plaintiffs and their lawyers must attempt to predetermine tax consequences of settlements or judgments based not only on the law of the state wherein the transaction occurs,<sup>88</sup> but also on the federal circuit in which a potential appeal would lie.<sup>89</sup> Thus, plaintiffs and defendants in different jurisdictions are likely to anticipate different results and therefore act accordingly in planning and litigating these cases.

Second, the federal circuits that have allowed nonphysical injury plaintiffs to exclude attorney fee portions of settlements or judgments have done so in part based on the “vagaries of state law.”<sup>90</sup> It is not unusual for a federal tax treatment of certain transactions to be determined by state law. Examples include, but are not limited to the following: federal tax treatment of corporate mergers,<sup>91</sup> federal tax treatment of the limited liability company (“LLC”),<sup>92</sup> and

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85. *Kenseth*, 114 T.C. at 415.

86. Sager & Cohen, *supra* note 32, at 1104.

87. See Robert W. Wood, *Attorney’s Fees: A Few More Observations*, 88 TAX NOTES 701 (2000) (stating that “[e]ven the holdings [of the circuit court cases] are confusing. . . . [T]he facts are literally all over the map . . . [and] not very good”).

88. Plaintiff must not only determine what attorney lien statutes exist in the state, but must also predict how those statutes will likely be interpreted by the courts.

89. Plaintiff must ask, are we in the plaintiff-taxpayer friendly Fifth, Sixth or Eleventh Circuit? Or, are we in the First, Ninth, or Federal Circuit, where the old assignment-of-income doctrine will likely bar our ability to exclude legal fees from the plaintiff-taxpayer’s gross income?

90. Geier, *supra* note 72, at 542.

91. The tax-free treatment of corporate reorganizations under Code section 368 depends, in part, on whether the reorganization complies with state laws regarding mergers (i.e., “statutory merger” requirements). At least one author argues that eligibility for such tax-free reorganizations should no longer depend upon state law. See Steven A. Bank, *Article: Federalizing the Tax-Free*

application of various federal gift and estate tax provisions.<sup>93</sup> However, the reliance of the courts on varying state laws with regard to federal tax treatment of attorney fees in nonphysical injury settlements and judgments has created an unpredictable and harsh tax result for a class of persons largely consisting of plaintiffs who are acting on behalf of all persons as “private attorneys general”<sup>94</sup> to enforce a host of anti-discrimination statutes.

The current inconsistency among the courts distorts outcomes in litigation because taxpayers, if effectively advised by their attorneys, will make decisions based in part on tax consequences. Although it may be proper for tax policy to provide incentives (or disincentives) for taxpayers to conduct transactions in a certain manner, tax policy should not conflict with other public policy goals.

For example, under the current tax regime, one problem with the quagmire surrounding settlements and judgments in civil rights violation suits is that plaintiffs may be discouraged from pursuing their cases. The fee-shifting provisions of the civil rights laws were intended to encourage private enforcement of civil rights.<sup>95</sup> However, even if an employment discrimination plaintiff, who is concerned with the tax consequences of his settlement, attempts to avoid adverse tax results by careful drafting of his settlement agreement,<sup>96</sup> he may face opposing counsel who refuses to allow an agreement that refers to the plaintiff's portion as reimbursed employee expenses and attorney fees or who

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*Merger: Toward an End to the Anachronistic Reliance on State Corporation Laws*, 77 N.C.L. REV. 1307 (1999).

92. The LLC is a “hybrid entity” that provides insulation from liability to the same extent as a corporation. See William P. Strong, 700-2nd I.1., Tax (BNA) (2001) (citing Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1 (1995)). For a list of states that have enacted LLC statutes, see Samuel P. Starr & Robert J. Crnkovich, *Limited Liability Companies*, 725-1st Tax. Mgmt. (BNA) IV.B. (2000); see also Bruce P. Ely & Christopher R. Grissom, *The LLC Scoreboard*, 81 TAX NOTES 1005 (Nov. 1998). LLC formation and operation depends upon state law authorization. All fifty states and the District of Columbia have some form of authorizing statute in place. See Katherine E. Ramsey Roose, *Like-Kind Exchanges and Real Estate Transfer Taxes: Making Hay from the Single-Member Limited Liability Company*, 18 VA. TAX REV. 665 (1999). In December 1996, the Service and the Treasury Department issued regulations that define how LLCs and other entities will be treated. Under these “Check-the-Box” Regulations, an LLC will be treated as a partnership for federal income tax purposes, unless it elects to be treated as a corporation. See Treas. Reg. §§ 301.7701-1-3.

93. Code section 2518 provides that federal and gift estate tax treatment of disclaimer of gifts and bequests depends on local law. See Mary Moers Wenig, *Disclaimers*, 848-1st Tax Mgmt. (BNA) IV-I (2000). Other federal estate and gift tax consequences that rely on varying state laws include: whether there is a right of survivorship, whether joint tenancy can be revoked by the person who created it, and the marital status of tenants. See Robert T. Danforth, *Taxation of Jointly Owned Property*, 823-1st Tax Mgmt. (BNA) I-C (2000).

94. See *infra* Part II.A.4.

95. See discussion *infra* Part II.A.4; see also *Quaratino v. Tiffany & Co.*, 166 F.3d 422 (2d Cir. 1999). See generally Sager & Cohen, *supra* note 32.

96. See Sager & Cohen, *supra* note 32, at 1101.



may require a premium for the result.<sup>97</sup> The possibility opposing counsel may act in such a manner is the result of the unsound tax policy created by the courts. The unequal treatment of civil rights plaintiffs and physical injury plaintiffs could, however, be resolved by a simple amendment to the Code that authorizes civil rights (and other nonphysical personal injury) plaintiffs to exclude or fully deduct attorney fees awarded in settlements or judgments.

4. *Preserving the Fee-Shifting Provisions of Anti-Discrimination Statutes.*— Full deductibility or exclusion of attorney fee awards would preserve the fee-shifting provisions of the federal anti-discrimination laws.<sup>98</sup> Congress has enacted a number of civil rights statutes aimed at eliminating discrimination.<sup>99</sup> The purpose of civil rights legislation has been to “provide real remedies to victims of discrimination,”<sup>100</sup> to entitle successful plaintiffs to have attorney fees paid by the losing defendant,<sup>101</sup> and to encourage plaintiffs to further the end of discrimination via their attorneys acting as “private attorneys general.”<sup>102</sup> Though beyond the scope of this Note, a compelling argument exists that civil rights laws are being undermined because *any* damages arising from nonphysical personal injuries are no longer excludable from a plaintiff’s gross income.<sup>103</sup>

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97. *Id.*

98. *Id.*

99. *See, e.g.*, Civil Rights Act of 1991 § 302, 2 U.S.C. § 1202 (1994 & Supp. V 1999); Congressional Accountability Act of 1995 §§ 201-07, 2 U.S.C. §§ 1311-17 (Supp. V 1999); The Fair Labor Standards Act of 1938, 29 U.S.C. §§ 201-19 (1994 & Supp. V 1999); The Employee Polygraph Protection Act of 1988, 29 U.S.C. §§ 2001-09; (1994 & Supp. V 1999); Age Discrimination in Employment Act of 1967 §§ 4, 15, 29 U.S.C. §§ 623, 633a (1994 & Supp. V 1999); Rehabilitation Act of 1973 §§ 501, 504, 29 U.S.C. §§ 791, 794 (1994 & Supp. V 1999); Employee Retirement Income Security Act of 1974 § 510, 29 U.S.C. § 1140 (1994); The Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§ 2101-09 (1994 & Supp. V 1999); Family and Medical Leave Act of 1993 § 105, 29 U.S.C. § 2615 (1994); Civil Rights Act of 1964 §§ 703, 704, 717, 42 U.S.C. 2000e-2, 2000e-3, 2000e-16 (1994 & Supp. V 1999); Fair Housing Act §§ 804, 805, 806, 808, 818, 42 U.S.C. §§ 3604, 3605, 3606, 3608, 3617 (1994 & Supp. V 1999); Americans with Disabilities Act of 1990 §§ 102, 202, 302, 503, 42 U.S.C. §§ 12112, 12132, 12182, 12203 (1994 & Supp. V 1999); Violence Against Women Act of 1994 § 40302, 42 U.S.C. § 13981 (1994 & Supp. V 1999). The above statutes are some of those listed in Senate Bill 2887, Civil Rights Tax Fairness Act of 2000, that seeks to amend the Code to allow civil rights plaintiffs to exclude all damage amounts received on account of “unlawful discrimination” from their gross income. *See* S. 2887, 106th Cong. § 2 (2000).

100. 146 CONG. REC. S7160-03, \*S7162-64 (statement by Sen. Grassley).

101. *Id.* (citing a letter from Victoria Herring, Attorney, to Charles Grassley, Senator, U.S. Senate and Tom Harkin, Senator, U.S. Senate (Nov. 30, 1999)).

102. *Id.*; *see also* Brief of Amici Curiae Nat’l Employment Lawyers Ass’n, et al. at 5, *Sinyard v. Comm’r*, 76 T.C.M. (CCH) 654 (1998) (citing *Newman v. Piggie Park Enterprises*, 390 U.S. 400, 402 (1968) for the proposition that fee-shifting provisions of civil rights laws encourage the victim of discrimination to act “as a ‘private attorney general’ vindicating a policy that Congress considered of the highest priority.”).

103. It seems unjustifiable to prevent plaintiffs from excluding such recovery from their gross

Nevertheless, at the very least, the Code should be amended to allow victims of civil rights violations to exclude (or fully deduct) the attorney fees portion of the award to avoid the consequences of the miscellaneous itemized deduction and the AMT combination that may render their award de minimus once attorney fees and taxes have been paid.<sup>104</sup>

5. *A Plug for the Floodgates of Litigation.*—The solution advocated in this Note would put an end to the incessant litigation that arises from the current conflict. Exclusion or full deductibility of attorney fees awarded in nonphysical injury claims would encourage settlement. The current tax treatment of attorney fees fosters an environment wherein fewer claims are settled because plaintiffs have a “net” recovery in mind.<sup>105</sup> The attorney for a nonphysical injury plaintiff will of course seek this net recovery for her client. However, according to some courts’ interpretation of the Code, the tax treatment of the attorney fee portion of a client’s settlement forces the plaintiff to ask for more than would otherwise be offered in settlement negotiation. Thus, nonphysical injury plaintiffs and defendants are unable to settle claims as effectively because the tax consequences deplete a substantial portion of a civil rights plaintiff’s recovery.<sup>106</sup>

“Because of the tax bite, businesses have to pay more or individuals have to take less to get settlements, or there are no settlements. A lot of cases are on the docket longer, and there are more trials.”<sup>107</sup> A plaintiff’s net recovery, once reduced by the tax consequences of the miscellaneous itemized deduction and the AMT leave “attorneys for both sides attempting to reach a solution that has become nearly impossible.”<sup>108</sup> Moreover, public policy favors the pre-trial

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income. In so doing, Congress implies that unlawful discrimination is a less harmful or egregious personal injury than physical injury caused by negligence or some other tort. Congress’ 1996 decision to amend the Code that created the current prohibition is contrary to its thirty-year policy of providing remedies to victims of past and present discrimination. In summary, exclusion of damages arising from unlawful discrimination reinforces the intent of decades of civil rights legislation and allows fair and appropriate remedies for discrimination victims. See 146 CONG. REC. S7160-03 (statement of Sen. Grassley). See generally Sager & Cohen, *supra* note 32.

104. See Sager & Cohen, *supra* note 32, at 1104, where they argue that

the tax law should be amended to permit civil rights plaintiffs either to deduct fully or exclude the portion of a civil rights recovery expended for attorney’s fees. The tax law should not be construed or constructed to overstate and overtax the income of civil rights plaintiffs and thereby subvert the national policy of ending unlawful discrimination.

See also Brief of Amici Curiae Nat’l Employment Lawyers Ass’n, et al. at 5, *Sinyard v. Comm’r*, 76 T.C.M. (CCH) 654 (1998).

105. Brief of Amici Curiae Nat’l Employment Lawyers Ass’n, et al. at 5, *Sinyard v. Comm’r*, 76 T.C.M. (CCH) 654 (1998).

106. Coyle, *supra* note 33, at A1.

107. *Id.* (quoting employment lawyer Frederick M. Gittes, a partner at Spater, Gittes, Schulte & Kolman in Columbus, Ohio).

108. Brief of Amici Curiae Nat’l Employment Lawyers Ass’n et al., *Sinyard v. Comm’r*, 76 T.C.M. (CCH) 654 (1998).



settlement of disputes.<sup>109</sup> This goal is frustrated by the current predicament imposed on nonphysical plaintiffs and defendants by the tax law. Amendment of the Code to allow full deduction or exclusion of the attorney fee portion of nonphysical injury awards would alleviate already heavy burdens imposed on the courts and reduce dockets by increasing incentive for parties to settle.

### *B. Suggested Resolutions*

The foregoing discussion establishes that there is a conflict in the current federal tax law that leads to harsh and unjust results in income tax liability for nonphysical injury plaintiffs. Moreover, the conflict should be resolved for a number of important reasons. Assuming that the remedy to the federal circuit court split is to allow nonphysical personal injury plaintiffs to fully deduct or exclude the attorney fee portions of their recoveries, one must address the means by which the law should be corrected. More specifically, one must question whether the courts or Congress should resolve the controversy.

1. *A Resolution by the Courts.*—As previously discussed, the Fifth, Sixth, and Eleventh Circuits have fashioned a fair resolution—that the attorney fee portion of the plaintiff's damages should not be included in the plaintiff's gross income.<sup>110</sup> However, these courts arrived at their result by means of state law—a somewhat tenuous ground because of the varying state attorney lien laws. The analysis used in those cases does not translate into a workable solution that can be applied in every case because attorney liens statutes differ immensely from state to state.<sup>111</sup>

At least one commentator notes that in addition to the uneven application of state law, the distinctions between whether the plaintiff had control over or rights to attorney fee awards “should be meaningless.”<sup>112</sup> Essentially, under the assignment-of-income doctrine, control is the issue. For example, in *Cotnam*, the operation of the Alabama attorney lien statute led the court to conclude that Cotnam never had control over amounts subsequently paid to her attorneys. Rather, the attorneys were the sole owners of that right to income during the entire lawsuit. However, “[h]aving to pigeonhole the analysis into the ill-fitting assignment-of-income doctrine invites the creation of just such distinctions.”<sup>113</sup> Cases applying the assignment of income doctrine demonstrate

how trying to resolve the problem favorably for the sympathetic class . . . can wreak havoc when application of that same doctrine in a case like *Baylin* would allow a taxpayer to effectively deduct a nondeductible capital expenditure. If, for example, a civil rights litigant succeeds in excluding the portion of the attorneys' fees paid to his attorneys, . . . no

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109. *Id.* (citing 42 U.S.C. § 1981, 2000e-5(b) provisions regarding pre-litigation dispute resolution).

110. *See supra* note 36.

111. *See supra* note 66.

112. Geier, *supra* note 72, at 52.

113. *Id.*

grounds [exist] on which to differentiate the plaintiff in *Baylin*, who . . . should be denied deduction of the attorneys' fees (in favor of capitalization) and should not be able to avoid that result through the back door. Collapsing the "income" and "deduction" into a single-step "exclusion" can lead to results that would be wrong if we gave each step tax significance. Curing the problem on the deduction side of the ledger would ensure that only those attorneys' fees that are properly deductible (because they are "expenses" rather than "capital expenditures") would escape taxation.<sup>114</sup>

Thus, the courts' application of the assignment-of-income doctrine to exclude attorney fees awarded to nonphysical injury plaintiffs is inadequate to resolve the problem entirely. The inadequacy exists because the courts' analysis is based on varying state law and may be misplaced with regard to some plaintiffs who, although they have suffered nonphysical injury (e.g., condemnation of land), are actually expending nondeductible capital expenses to redeem value of lost capital gain.

The problems with *Cotnam* and its progeny do not stop there. Another commentator has noted that the courts' analysis in *Cotnam*,<sup>115</sup> *Estate of Clarks*,<sup>116</sup> and *Davis*<sup>117</sup> "is incomplete because [they] failed to consider the implications of [Code section] 83."<sup>118</sup> Code section 83 provides that property exchanged for services is disregarded for federal income tax purposes until the "substantial risk of forfeiture" lapses.<sup>119</sup> The argument against *Cotnam* and its forebears is that once those courts determined that contingent fee arrangements operated to transfer a portion of a plaintiff's claim to his attorney via state attorney lien statutes, Code section 83 should have applied to the transfer. The substantial risk of forfeiture is created by the possibility that the attorney may be discharged or voluntarily withdraw from the case before settlement or judgment. However, the transfer does not take place until settlement or judgment, at which time the plaintiff transfers the attorney fee portion of his award to his attorney who includes that amount in his or her gross income. The plaintiff may deduct the attorney fees under Code sections 83 and 162.<sup>120</sup> This view asserts that the

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114. *Id.* (footnotes omitted).

115. 263 F.2d 119 (5th Cir. 1959).

116. 202 F.3d 854 (6th Cir. 2000).

117. 210 F.3d 1346 (11th Cir. 2000).

118. Gregg D. Polsky, *Taxing Contingent Attorneys' Fees: Many Courts Are Getting It Wrong*, 89 TAX NOTES 917 (2000); see *supra* notes 36-37 and accompanying text (arguing that the courts in those cases reasoned that nonphysical injury plaintiffs could exclude from their gross income attorney fees awarded in settlements or judgments because the attorney lien statute in the relevant states gave attorneys rights to their fees and thus, the assignment-of-income doctrine could not be applied to force plaintiffs to include attorney fees in their gross income).

119. I.R.C. § 83 (1994).

120. In the case of transfer of property in connection with the performance of services, Code section 162 allows the individual for whom the services were performed, a deduction in the amount



attorney fee award should not be excluded from the plaintiff's income. Rather, the entire settlement or judgment amount is included in plaintiff's gross income, subject to deductions allowed by Code sections 83 and 162.<sup>121</sup>

Therefore, if the federal circuits are either "getting it wrong" or cannot reach a consensus because of the vagaries of state law, a resolution from the nation's highest Court would be helpful. However, a decision from the Supreme Court would not be the most desirable solution because the issue would likely be resolved based upon the court-made doctrines that have aided in creating the problem.<sup>122</sup> Regardless, such a decision may be long in coming.<sup>123</sup>

A second view that involves a court-made resolution was suggested by U.S. Tax Court Judge Beghe in his *Kenseth* dissent.<sup>124</sup> Judge Beghe argues that the courts can and should resolve the conflict. He argues that because court-made law<sup>125</sup> has contributed to the problem, courts have the authority to ameliorate the conflict. In light of *Cotnam* and its progeny, Judge Beghe distinguishes two separate grounds upon which the courts could resolve the issue of the excludability of attorney fees in nonphysical injury settlements and judgments. One is the "narrow ground," namely that state attorney lien statutes are interpreted to decide the outcome of the federal income tax treatment of income for non-physical injury plaintiffs.<sup>126</sup> The other is the "broader ground," namely that the contingent fee plaintiff lacks substantial control over the attorney fee income to include it in his gross income.<sup>127</sup> The latter view avoids the anomaly created by the application of varying state laws to decide such a fundamental federal income tax consequence. Since the broader ground avoids state law application, it would at least provide a resolution that could be applied in every case. Judge Beghe points out that the narrower ground makes a determination

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equal to the amount included in the gross income of the person who performed such services. *Id.* § 83(h). Code section 162 defines a deduction for ordinary and necessary expenses used in trade or business. Of course, this is a "below the line" deduction subject to the two percent floor and thus, the plaintiff does not get to fully deduct the amount paid to his attorney. *Id.* § 162 (1994 & Supp. V 1999).

121. "The result would be the same even under the Sixth Circuit's partnership theory." Polsky, *supra* note 118, at 55.

122. See Geier, *supra* note 72, at 76.

123. See Robert W. Wood, *Even Tax Court Itself Divided on Attorneys' Fees Issue!*, 88 TAX NOTES 573 (2000).

124. *Kenseth v. Comm'r*, 114 T.C. 399, 421 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001) (Beghe, J., dissenting).

125. Application of the assignment-of-income doctrine forces nonphysical personal injury plaintiffs to pay income tax on the portion of their awards paid for legal fees. Since the doctrine is not mandated by the Code and was created by the courts, tax controversies can be properly settled without its application. Furthermore, Judge Beghe argues that the assignment-of-income doctrine is outdated and applies to a limited amount of cases. Thus, the assignment-of-income doctrine should not extend to cases involving personal injury litigation. *Id.*

126. *Id.* at 433-38.

127. *Id.* at 438-42.

based on “attenuated subtleties” and “refinements” of state law that should be disregarded.<sup>128</sup> Whereas, the broader ground, where one asks whether the plaintiff in contingent fees cases ever “controlled” the income, provides a more appropriate means to achieve the same result.

However, the broader ground only applies to contingent fee arrangements because it is based on the plaintiff’s control over the award received. In a contingent fee arrangement (versus a flat fee or by the hour fee arrangement), the plaintiff relinquishes control of the funds from the beginning of the litigation. Although the vast majority of nonphysical personal injury plaintiffs are likely to use the contingent fee arrangement to pay for legal services, the few plaintiffs that pay via a flat fee or by the hour “slip through the cracks” and are unable, under Judge Beghe’s approach, to exclude attorney fees recovered when they are awarded a judgment or reach a settlement. Moreover, as previously discussed, the distinction between *how* the plaintiff pays for his attorney should be irrelevant.<sup>129</sup>

Despite the courts’ apparent ability or authority to resolve the issue entirely, the courts may not represent the best means for resolution because it may be difficult for the courts to articulate a rule of broad applicability for all nonphysical personal injury cases. Congress, however, as the creator and amender of the Code, does have the ability to prescribe a direct solution to the arbitrary tax impact of the Code on nonphysical personal injury plaintiffs awarded attorney fees in settlements and judgments.

2. *A Resolution from Congress – Amending the Code.*—There are at least three ways in which the federal circuit conflict could be resolved by Congress’ amending of the Code. First, if Congress decides to act on the basis that the conflict is a “deduction” issue and not a “gross income” issue, the circuit split could be resolved by amending Code section 67<sup>130</sup> to add “attorney fees paid under Code sections 162<sup>131</sup> or 212<sup>132</sup>” to the list of exceptions not subject to the two percent floor for miscellaneous itemized deductions.<sup>133</sup> Alternatively, the split could be resolved by adding “attorney fees paid under Code sections 162 or 212” to the list of “above the line” deductions listed in Code section 62.<sup>134</sup>

Second, the federal circuit conflict could be resolved, at least for civil rights plaintiffs, if Congress were to pass, and the President were to sign, Senate Bill 2887.<sup>135</sup> This proposed bill may largely reconcile the current conflict because the

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128. *Id.* at 428, 432.

129. *See supra* note 124.

130. I.R.C. § 67 (1994).

131. *See id.* § 162 (1994 & Supp. V 1999) (defining “below the line” deduction for trade and business expenses).

132. *See id.* § 212 (defining “below the line” deduction for production of income expenses).

133. Geier, *supra* note 72.

134. *Id.*

135. *See* S. 2887, 106th Cong. § 2 (2000). The last action taken on Senate Bill 2887 as of this writing was that it was referred to the Senate Finance Committee. Its companion bill, House Bill 1997 is also in committee.



most frequent context in which this issue has arisen is the civil rights arena, particularly, employment discrimination.<sup>136</sup> Moreover, this proposed bill would allow civil rights victims to exclude their entire recovery, twice their gross income, a practice which would be consistent with our nation's policy against unlawful discrimination.

Third, the circuit conflict could be resolved by amending Code section 104 to exclude from gross income attorney fees that are awarded as part of a judgment or settlement for nonphysical injury. Such an amendment would satisfy a variety of needs. First, it would eliminate confusion and potential abuse that would be incurred by amending the Code sections concerning deductions. Second, as a matter of principle, the amount paid to attorneys should not be included in the gross income of a plaintiff who had no control over such income and never received the income. Additionally, such an amendment would reinforce the intent of civil rights statutes by at least allowing such plaintiffs to exclude attorney fees. Finally, the amendment would put an end to the ongoing litigation that arises out of these tax controversies. Furthermore, the burden to prove an exclusion remains with the taxpayer.<sup>137</sup>

### III. THE BEST RESOLUTION TO THE FEDERAL CIRCUIT COURT SPLIT

The federal circuit court conflict can be best resolved by a Congressional amendment to Code section 104. The bill would simply amend Code section 104 to exclude "amounts received (whether by suit or agreement) by a claimant on account of nonphysical personal injury that are designated for and actually paid as attorney fees for services that related to the suit or agreement."<sup>138</sup>

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136. *Coady v. Comm'r*, 213 F.3d 1187 (9th Cir. 2000) (wrongful termination), *cert. denied*, 121 S. Ct. 1604 (2001); *Alexander v. Comm'r*, 72 F.3d 938 (1st Cir. 1995) (breach of contract and age discrimination); *Kenseth v. Comm'r*, 114 T.C. 26 (2000) (age discrimination), *aff'd*, 259 F.3d 881 (7th Cir. 2001); *Hukkanen v. Comm'r*, 79 T.C.M. (CCH) 2122 (2000) (sex discrimination); *Sinyard v. Comm'r*, 76 T.C.M. (CCH) 654 (1998). (wrongful discharge). *Cf. Davis v. Comm'r*, 210 F.3d 1346 (11th Cir. 2000) (fraud, conspiracy and breach of contract); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000) (physical injury case in which issue was whether interest on attorney fees was excludable); *Baylin v. Comm'r*, 43 F.3d 1451 (Fed. Cir. 1995) (protest of condemnation); *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959) (breach of contract).

137. *Townsend v. United States*, 143 F. Supp. 150 (S.D. Ill. 1956).

138. The following is a draft bill that, if enacted, would end the entire controversy created by the federal circuit court conflict:

A Bill to amend the Internal Revenue Code of 1986 to exclude from gross income amounts received on account of claims based on nonphysical personal injury that are designated attorney fees.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the 'Tax Fairness to Plaintiffs Act of 2001.'

SECTION 2. EXCLUSION FROM GROSS INCOME FOR AMOUNTS RECEIVED

Several members of Congress and a number of commentators agree that the current tax law has created an unintended and egregious tax consequence for nonphysical injury plaintiffs. That consequence exists because of the courts' contradicting positions regarding the excludability of attorney fee portions of damage awards from plaintiffs' income. The problem is undeniable and obvious, as demonstrated by the first example discussed in this Note. However, there are disagreements over how to resolve the current controversy.

Unless the U.S. Supreme Court were to grant certiorari to a prototypical case and apply the reasoning of the Fifth, Sixth and Eleventh Circuits, the problem will not be resolved correctly by the courts. However, even if the Court did grant certiorari and apply the reasoning of those courts, the analysis by those courts is arguably questionable.

The solution, therefore, lies with Congress. In 1996, Congress created the problem when it enacted the Small Business Jobs Protection Act, which included an amendment that followed opinions by the Supreme Court suggesting damages from nonphysical injuries should not be excludable from gross income for federal income tax purposes. The amendment proposed by this Note would allow Congress to correct its harmful and unintended tax consequence to nonphysical personal injury plaintiffs.

The following explains the reasons for each of the operative words in the proposed Code amendment.

First, "claimant" has the same meaning as it does for other purposes within Code section 104. "Claimant" refers to individuals who have brought a cause of action against another individual. Second, the term "nonphysical" is a necessary term because the entire problem discussed in this Note stems from the distinction Congress made in 1996 by amending Code section 104 to only allow an exclusion for "physical" personal injury. Thus, the term "nonphysical" injury refers to those causes of action that are not physical in nature (e.g., civil rights claims, breach of contract, and fraud). Third, the term "personal" is used to indicate that the exclusion is provided for those nonphysical injuries to a person, not a person's property. This distinction should put to rest any concern with those plaintiffs seeking recovery of injury to property (e.g., the nondeductible capital expenditures cases like *Baylin*).

Lastly, the term "injury" refers to harm caused to the claimant. Harms such as breach of contract, fraud, or discrimination are just as harmful to individuals as physical harms. In addition, there is a strong public policy against discrimination. For these reasons, the tax implications of physical and

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#### ON ACCOUNT OF NONPHYSICAL PERSONAL INJURY

- (a) IN GENERAL. – Section 104 of the Internal Revenue Code of 1986 (relating to compensation for injuries or sickness, an item specifically excluded from gross income) is amended by inserting the following clause set forth in (b) after section 104(a)(5):
- (b) EXCLUSION. – "(6) amounts received (whether by suit or agreement) by a claimant on account of nonphysical personal injury that are designated for and actually paid as attorney fees for services related to the suit or agreement."



nonphysical injury settlements and judgments should be the same. Moreover, all laws, including the tax code, should not undermine these policies that have done so much to improve the fabric of our nation and mend past discrimination while preventing and discouraging future discrimination in any form.

### CONCLUSION

There are two points to be made regardless of whether, how, or to what extent this controversy is resolved. First, parties, and especially lawyers, on both sides of nonphysical personal injury litigation need to be aware of the current federal circuit court conflict and the impact it can have on settlements and judgments. The tax ramifications are real and, for better or worse, can and will be used to impact negotiations. Understanding the tax consequences associated with such settlements and judgments improves the ability of lawyers on both sides to handle settlement negotiations and, in turn, to provide better representation to their clients. Second, plaintiffs' lawyers handling nonphysical personal injury cases have a special obligation to inform their clients about the tax consequences involved. Plaintiffs' attorneys cannot ignore the Code's impact on settlements or judgments. Moreover, an attorney has the professional responsibility to help her client understand how the Code will affect his tax liability and his "net" recovery in settlement or judgment.

The present discussion exploring the best manner to alleviate the disparaging federal circuit court conflict over the deduction of attorney fees from a nonphysical personal injury plaintiff's gross income is, by its very nature, academic. Only action by the courts or Congress will redeem the faulty and unsound tax policy created by Code section 104 and the courts' interpretations of this portion of the Code. However, Congress, rather than the courts, should be the "final arbiter" of this conflict. It should amend Code section 104(a) so to exclude "amounts received (whether by suit or agreement) by a claimant on account of nonphysical personal injury that are designated for and actually paid as attorney fees for services related to the suit or agreement."





# THE H-2A PROGRAM: HOW THE WEIGHT OF AGRICULTURAL EMPLOYER SUBSIDIES IS BREAKING THE BACKS OF DOMESTIC MIGRANT FARM WORKERS

ANDREW SCOTT KOSEGI\*

## INTRODUCTION

Finding a ready source of agricultural labor has been a problem that has plagued agricultural employers since the emergence of the United States of America as a nation. Early attempts to force Native Americans to work in the fields failed miserably when the labor supply quickly dwindled from smallpox and other diseases.<sup>1</sup> As this failure became obvious, the focus shifted to the importation of labor from other countries.<sup>2</sup> Initially, the colonists brought over poor, white Europeans to meet their insatiable need for agricultural laborers; however, such efforts failed when these indentured servants abandoned their obligatory employment only to blend in with the other, white European settlers.<sup>3</sup> Next, resorting to the importation of dark-skinned Africans became the apparent way to distinguish those who were slaves from those who were the European colonists.<sup>4</sup> Additionally, given the seemingly unlimited supply of Africans, the slave trade provided the perfect answer to agricultural labor shortages.<sup>5</sup> Following the effects of the Emancipation Proclamation, the trend in the late nineteenth and early twentieth centuries was to import agricultural labor from Mexico.<sup>6</sup> Unfortunately, that trend appears to be continuing into the twenty-first century as proposed legislation attempts to mainstream the ability of agricultural employers to import foreign workers.

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1. See generally JOHN HOPE FRANKLIN & ALFRED A. MOSS, JR., FROM SLAVERY TO FREEDOM 38 (8th ed. 2000) (outlining initial use of Native Americans as agricultural slaves who eventually became weakened by diseases); WILBUR R. JACOBS, DISPOSSESSING THE AMERICAN INDIAN 122-23 (1972) (discussing Native American slavery and discussing the relationship between free American Indians and black slaves on colonial American farms); BERNARD W. SHEEHAN, SEEDS OF EXTINCTION 227-32 (1973) (describing the loss of entire Native American villages to smallpox and other epidemic diseases).

2. FRANKLIN & MOSS, *supra* note 1, at 38.

3. *Id.* at 39.

4. *Id.*

5. *Id.*

6. See, e.g., KITTY CALAVITA, INSIDE THE STATE: THE BRACERO PROGRAM, IMMIGRATION, AND THE I.N.S. 7 (1992) (suggesting that Mexican laborers instead of European immigrants were more beneficial to U.S. agriculture because Mexicans could be forced to return to their country more easily when the contracted work was completed). For a history of early use of Mexican labor in the United States, see ERNESTO GALARZA, MERCHANTS OF LABOR: THE MEXICAN BRACERO STORY (1964).

Today, a federal program exists whereby U.S. growers, unable to find sufficient U.S. labor, may request permission to import temporary foreign agricultural workers. It is called the H-2A Program.<sup>7</sup> However, legislation introduced in Congress over the past few years would substantially alter that program for the worse. Such legislation has been fueled by a desire to improve the ability of agricultural employers to import foreign agricultural workers more easily than allowed by the purportedly cumbersome current program.<sup>8</sup> Yet, the proposed alterations to the present program would not only be devastating to the foreign workers imported to work on U.S. farms, but they would further set back any progress in working conditions of U.S. farm workers.

This Note will address several different aspects of the H-2A Program. Part I will focus on the historical framework from which the program has evolved. Part II will lay out the specifics of the present H-2A Program in detail. Part III will highlight the proposed legislation that has failed to pass during the past few sessions of Congress. Part IV will address the policy concerns involved with the program and explain the types of changes necessary to protect better the workers involved. Finally, Part V will propose solutions to the overarching policy concerns involved.

## I. HISTORICAL BACKGROUND

The current H-2A Program does not exist in a vacuum. Instead, it has evolved from an elaborate and contentious history. To fully grasp the import of the current program and the proposed changes to it, one should begin with a thorough understanding of its predecessors and how the program came into existence.

### A. Pre-Bracero Years

The United States has a lengthy history of permitting the importation of Mexican laborers. In the 1880s, Mexican citizens were used in the southwestern United States as agricultural workers and railroad workers.<sup>9</sup> This practice occurred even though the "Anti-Alien Contract Labor law of 1885" made it

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7. The program is not so creatively named from the source within immigration law that classifies the imported workers as nonimmigrant aliens, 8 U.S.C. § 1101(a)(15)(H)(ii)(A) (1994).

8. See *Agricultural Opportunities Act: Hearing on H.R. 4548 Before the Subcomm. on Immigration and Claims of the House Comm. on the Judiciary*, 106th Cong. 78 (2000) (statement of Rep. Richard W. Pombo) ("The current H-2A program which is used to assist in maintaining a stable agriculture workforce is over 50 years old and with so many bureaucratic problems that, in short, it is a nightmare to obtain workers in a timely manner."). Ironically, recent statistics indicate an increased reliance on H-2A workers. See IMMIGRATION & NATURALIZATION SERV., U.S. DEP'T OF JUSTICE, 1998 STATISTICAL YEARBOOK OF THE IMMIGRATION AND NATURALIZATION SERVICE 31 (2000) (indicating that 27,308 H-2A workers were admitted in 1998, compared to the 9635 admitted in 1996). Undoubtedly, this number has grown since 1998.

9. CALAVITA, *supra* note 6, at 7.



unlawful to import unskilled laborers for employment purposes.<sup>10</sup> In response to the need for additional laborers from Mexico in the early twentieth century, immigration officials exempted Mexicans from quotas and literacy requirements.<sup>11</sup> This practice violated the Immigration Act of 1917,<sup>12</sup> which prohibited the importation of persons by employment offers.<sup>13</sup> These policies continued through World War I and promoted Mexican immigration to the United States.

However, the policy goal was not only to have an expanding source of labor available, but to restrict that source as deemed necessary. Thus, in the 1920s, twenty percent of Mexican laborers' earnings were withheld by the Department of Labor.<sup>14</sup> Upon the laborers' return to Mexico, their withholdings would be returned.<sup>15</sup> Moreover, during the Depression of the 1930s, a massive anti-immigrant movement culminated in the forcible "repatriation" of Mexican laborers.<sup>16</sup> These policies attested to the dispensability of Mexican labor when the economy took a turn for the worse.

### *B. Bracero Program: 1942-1964*

1. *Wartime Program.*—In 1941, many U.S. growers requested that Mexican agricultural laborers be allowed to enter the country again; however, the federal government rejected such requests, stating that there was no labor shortage.<sup>17</sup> The policy changed, however, in 1942, after the bombing of Pearl Harbor.<sup>18</sup> As the United States entered World War II, farmers quickly noted that importation of foreign workers would allow for greater production and thus contribute to the national defense.<sup>19</sup> In April 1942, a governmental committee was formed to address the growing need for agricultural laborers.<sup>20</sup> This committee was comprised of members from the Departments of Labor, State, Agriculture, Justice, and the War Manpower Commission.<sup>21</sup> The committee quickly approved a plan for importing Mexican laborers.<sup>22</sup> Shortly thereafter, the U.S. government

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10. *Id.* at 6; *see also* Act of Feb. 26, 1885, ch. 164, 23 Stat. 332 (repealed 1952).

11. CALAVITA, *supra* note 6, at 6-7.

12. Ch. 29, 39 Stat. 874 (repealed 1952).

13. *Id.* § 3, at 876.

14. CALAVITA, *supra* note 6, at 7.

15. *Id.*

16. Juan Gómez-Quiñones, *Mexican Immigration to the United States and the Internationalization of Labor, 1848-1980: An Overview*, in *MEXICAN IMMIGRANT WORKERS IN THE U.S.* 25 (Antonio Rios-Bustamante ed., 1981).

17. RICHARD B. CRAIG, *THE BRACERO PROGRAM* 38 (1971).

18. *Id.* at 38-40.

19. *Id.* at 39.

20. *Id.* at 39-40.

21. *Id.* at 40; *see also* CALAVITA, *supra* note 6, at 19.

22. CRAIG, *supra* note 17, at 40.

approached the Mexican government to discuss a contract labor program.<sup>23</sup>

Within a few months, the two governments had arrived at a treaty creating the Bracero Program. The term "Bracero" commonly refers to the Mexican workers granted permission to work in the United States as a result of this program.<sup>24</sup> The responsibilities for its implementation were spread out over an array of federal agencies.<sup>25</sup> One author explained the differing governmental roles, stating:

From 1942 to 1947, the Department of Agriculture had primary authority for coordinating the Bracero Program, but its operation involved a complex network of interagency responsibilities. The agreements with Mexico were negotiated largely by the Department of State; the United States Employment Service was responsible for certifying labor shortages and estimating prevailing wages; the Farm Security Administration—and later the War Food Administration—did the actual recruitment and contracting; and the INS authorized and oversaw the admission and return of the workers.<sup>26</sup>

Under the terms of the bilateral agreement, most U.S. growers<sup>27</sup> were allowed to use foreign agricultural workers from Mexico, as long as there was a shortage of U.S. workers.<sup>28</sup> The agreement also required that the Mexican citizens not be used in the U.S. military, and that they be treated fairly and guaranteed certain worker protections.<sup>29</sup> One major concession that the Mexican government demanded was that the contracted workers must be employed not by individual growers, but by the U.S. government itself.<sup>30</sup> Thus, any grievances would be resolved between the governments and not between the individual actors.<sup>31</sup> Further, the agreement called for the U.S. government to fund the transportation of the workers to and from Mexico and the work sites.<sup>32</sup> Also, the workers were paid at least the same prevailing wage rate other agricultural workers received, with an absolute minimum of thirty cents per hour.<sup>33</sup> Finally, Mexican laborers were to be guaranteed three-quarters of the work promised by the contract and ten percent of their pay was to be held back and sent to a Mexican bank where

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23. *Id.*

24. The name "bracero" is derived from the Spanish word *brazo*, which in English means "arm" and "hints at the function these braceros were to play in the agricultural economy." CALAVITA, *supra* note 6, at 1.

25. *Id.* at 20.

26. *Id.* at 20-21.

27. Texas growers were specifically excluded from the program after Mexican officials cited a repeated history of worker abuses. *Id.* at 20.

28. *See id.* at 20.

29. CRAIG, *supra* note 17, at 43.

30. *Id.*

31. *Id.* at 44.

32. *Id.*

33. *Id.*



it would be held for the workers.<sup>34</sup>

2. *Ad Hoc Post-War Extensions*.—From 1942 to 1947, over 200,000 Braceros were officially granted permission to perform agricultural labor.<sup>35</sup> On April 28, 1947, well after World War II had ended, Congress eventually called for the wartime Bracero Program to be terminated by December 31, 1947.<sup>36</sup> However, because of concern expressed by agricultural employers over the loss of their steady labor supply, the program did not officially come to an end at that time.<sup>37</sup> Instead, the Department of State, on February 21, 1948, formed a new agreement with the Mexican government to continue importing agricultural labor.<sup>38</sup> This agreement, created almost entirely by administrative agencies, differed greatly from the wartime Bracero Program.<sup>39</sup> The most significant changes involved the nature of the employment contracts. The U.S. government was no longer the employer; rather, the agreements were now between individual growers and the Bracero workers.<sup>40</sup> Also, the growers themselves were responsible for recruiting and transporting Mexican workers to and from Mexico and the farms.<sup>41</sup> Additionally, the changes failed to establish a minimum hourly wage and did not guarantee pay for lack of promised employment.<sup>42</sup> As the program was implemented, illegal entrants, the new source of labor, were arriving in large numbers.

Actions taken on both sides of the border contributed to increased illegal immigration from 1948 to 1951. First, the United States took a laissez-faire approach to immigration enforcement.<sup>43</sup> Growers were especially supportive of an open border, as it would provide an easier way to obtain workers.<sup>44</sup> Second, Mexico mistakenly believed that agreeing to grant Bracero positions first to those already illegally in the United States would curb the exodus of Mexicans across the border.<sup>45</sup> On the contrary, the policy only increased the illegal entry of

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34. *Id.* at 44-45. Recently, a class action lawsuit was filed against the U.S. government, the Republic of Mexico, and various banks on behalf of Braceros who never received these withdrawn earnings. Rich Connel & Robert J. Lopez, *Mexican Report Contradicts Claims that '40s War Workers Weren't Paid*, L.A. TIMES, Mar. 30, 2001, at A3, available at 2001 WL 2474131.

35. CALAVITA, *supra* note 6, at 20-21 (citing CONG. RESEARCH SERV., HISTORY OF THE IMMIGRATION AND NATURALIZATION SERVICE 65 (1980)).

36. *Id.* at 25.

37. *See id.*

38. *Id.*

39. *Id.* at 27; *see also* CRAIG, *supra* note 17, at 53.

40. CRAIG, *supra* note 17, at 53.

41. *Id.* at 54.

42. *See id.*

43. *Id.* at 63; *see also* CALAVITA, *supra* note 6, at 29 (both citing NELSON GAGE COPP, "WETBACKS" AND BRACEROS: MEXICAN MIGRANT LABORERS AND AMERICAN IMMIGRATION POLICY, 1930-1960, at 189 (R. & E. Research Assocs. 1971) (1963)).

44. *See* CALAVITA, *supra* note 6, at 35.

45. *Id.* at 28.

Mexicans into the United States.<sup>46</sup>

It took another wartime situation, the Korean War, before any substantial changes were made to the informal Bracero agreements.<sup>47</sup> In 1950, the United States entered into the Korean War, and again growers called for the admission of more Mexican agricultural workers.<sup>48</sup> However, before the Mexican government would agree to let more of its citizens enter the United States as Braceros, it demanded that control of the program revert back to the U.S. government instead of remaining with the individual growers.<sup>49</sup>

In March 1951, the President's Commission on Migratory Labor released a report<sup>50</sup> which focused on the harmful effects of Braceros on the domestic workforce. In particular, the report suggested that the program allowing for the importation of foreign agricultural workers depressed the wages of domestic workers.<sup>51</sup> It stated that "[i]n the normal competitive market, prices, including the price of labor, are determined by the forces of supply and demand. Accordingly, if there is a labor shortage, the price of labor should rise. Yet the opposite of this actually has occurred with wages of migratory farm workers."<sup>52</sup> The Commission made several recommendations on how to improve the situation. To curb the flow of illegal immigration, it suggested strengthening immigration laws, especially by penalizing U.S. employers that use illegal workers.<sup>53</sup> Further, it recommended that "[f]uture efforts be directed toward supplying agricultural labor needs with our own workers and eliminating dependence on foreign labor."<sup>54</sup>

3. *Public Law 78: Solidifying the Future of the Program.*—In June 1951, Congress passed Public Law 78.<sup>55</sup> In response to the concerns of the Mexican government, the legislation restored the United States as government guarantor of the Bracero contracts.<sup>56</sup> Further, the legislation had requirements similar to the previous Bracero accords; specifically, that there be insufficient labor in the United States; no adverse affect on wages or working conditions of domestic

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46. *Id.*; cf. GALARZA, *supra* note 6, at 64 (asserting that legalization of illegal entrants eased border enforcement problems for the United States and maintained a steady labor supply to U.S. growers).

47. See CRAIG, *supra* note 17, at 66.

48. CALAVITA, *supra* note 6, at 43.

49. *Id.*

50. See THE PRESIDENT'S COMM'N ON MIGRATORY LABOR, MIGRATORY LABOR IN AMERICAN AGRICULTURE iii (1951).

51. See *id.* at 60-61.

52. *Id.* at 60.

53. *Id.* at 88.

54. *Id.* at 36.

55. See Mexican Agricultural Workers Importation (Wetback) Act, ch. 223, 65 Stat. 119 (1951) (amended 1953, 1954, 1955, 1958, 1960, 1961, and 1963; no longer effective by its own terms as amended).

56. CALAVITA, *supra* note 6, at 43-44.



workers; and “reasonable efforts” to recruit U.S. workers.<sup>57</sup> The legislation was notable, however, in its lack of response to the recommendations of the President’s Commission.<sup>58</sup> Critics of the legislation noted three problems with the legislation: its lack of guidance on how to assess whether there was a labor shortage; its lack of a system for establishing a prevailing wage; and the absence of criminal penalties for continued use of illegal workers.<sup>59</sup> Immediately following President Truman’s reluctant signature on the passed legislation,<sup>60</sup> negotiations began on a new treaty between Mexico and the United States to provide U.S. growers with agricultural workers.<sup>61</sup>

The two countries signed a new Bracero treaty on August 2, 1951.<sup>62</sup> Due to the leverage that the Mexican government exerted over the process, it was able to negotiate multiple benefits and protections for the Bracero workers, including free transportation to and from Mexico, a prevailing wage rate, work guarantees, insurance (even when state law did not require the same for domestic workers), cooking facilities or provided meals, housing, tools, and the right to join labor unions.<sup>63</sup> However, rather than making a long-term commitment, the Mexican government only agreed to a six-month trial period.<sup>64</sup> The Mexican government sought a trial period primarily because it wanted to see if the U.S. Congress would pass legislation to penalize U.S. employers for using illegal immigrants. Siding with the Mexican government, President Truman called upon Congress to pass similar penalties, or he would terminate the Bracero Program.<sup>65</sup>

In response to concerns by the Mexican government and President Truman, S. 1851<sup>66</sup> was introduced in the Senate.<sup>67</sup> After the House passed a different form of the bill and the conference committee had agreed upon a final version, S. 1851 became law when President Truman signed Public Law 283 on March 20, 1952.<sup>68</sup> Following the passage of Public Law 283, the Mexican government would not agree to the long-term extension of the Bracero Program without additional guarantees.<sup>69</sup> Critical to the Mexican government was that the new treaty call for

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57. CRAIG, *supra* note 17, at 74.

58. *Id.* at 75; *see also* CALAVITA, *supra* note 6, at 44.

59. CALAVITA, *supra* note 6, at 44.

60. CRAIG, *supra* note 17, at 71-72.

61. CALAVITA, *supra* note 6, at 45.

62. CRAIG, *supra* note 17, at 78.

63. *See id.* at 80-81. Although there were strong worker protections provided by law, growers did not always comply with them. *See infra* Part I.B.4.

64. CRAIG, *supra* note 17, at 78-79.

65. *Id.* at 94.

66. 82d Cong. (1951) (enacted).

67. CRAIG, *supra* note 17, at 78-79.

68. *See* Act of March 20, 1952, ch. 108, 66 Stat. 26 (1952) (amended 1952, 1978, 1981, 1986, 1988, 1994, 1996, and 2000). This law made it a crime to harbor or conceal illegal aliens; however, employing illegal aliens was not considered harboring or concealing for purposes of the statute. CRAIG, *supra* note 17, at 95.

69. *See* CRAIG, *supra* note 17, at 99.

the U.S. Secretary of Labor to determine the prevailing wage rate.<sup>70</sup> Eventually, on June 12, 1952, the two sides arrived at a new agreement.<sup>71</sup>

Around the same time that the new treaty was signed, Congress passed the Immigration and Nationality Act,<sup>72</sup> which included provisions authorizing the importation of H-2 workers.<sup>73</sup> Similar to the Bracero Program, the H-2 Program only allowed temporary workers to enter following a certified labor shortage. However, given the popularity of the recently enacted Bracero Program, most employers did not come to rely on the H-2 Program until after the demise of the Bracero Program.<sup>74</sup>

In 1954, when the Bracero Program was awaiting renewal, negotiations between the governments of Mexico and the United States crumbled.<sup>75</sup> In response to the Mexican government's demand for better worker protections, the United States threatened to institute a unilateral labor program without the input of the Mexican government.<sup>76</sup> As a result, another bilateral agreement between the United States and Mexico was reached on March 10, 1954, extending "the migrant-labor program to December 31, 1955."<sup>77</sup>

A major concern for both governments was the increase of illegal entries by Mexican citizens in search of employment opportunities in the United States.<sup>78</sup> To curb the flow of illegal entrants and to redirect reliance upon the new Bracero accords, the United States Immigration and Naturalization Service (INS), under the helm of Commissioner Joseph Swing, former General in the U.S. Army, commenced "Operation Wetback."<sup>79</sup> On June 17, 1954, a concerted effort at capturing illegal entrants began in California.<sup>80</sup> The operation soon spread

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70. *Id.* at 99 n.74.

71. *Id.* at 99.

72. Ch. 477, 66 Stat. 163 (1952) (codified as amended in scattered sections of 8 U.S.C.).

73. *See id.*

74. *See* H. Michael Semler, *The H-2 Program: Aliens in the Orchard: The Admission of Foreign Contract Laborers for Temporary Work in U.S. Agriculture*, 1 YALE L. & POL'Y REV. 187, 194 (1983); *cf.* CALAVITA, *supra* note 6, at 148 (stating that the reason growers did not use Mexican H-2 workers was an executive order).

75. CRAIG, *supra* note 17, at 108-09.

76. *See* H.R.J. Res. 355, 83d Cong. (1954) (replacing the bilateral agreement with a unilateral program instituted by the United States to recruit Mexican laborers if negotiations with the Mexican government over the terms of a bilateral agreement were unsuccessful). However, the two governments were soon able to agree on terms for renewal of the Bracero Program. CRAIG, *supra* note 17, at 121; *see also* GALARZA, *supra* note 6, at 69 (describing this law as "an effective weapon . . . placed in the hands of the American negotiators . . .").

77. *See* CRAIG, *supra* note 17, at 121-22.

78. *Cf. id.* at 126 (referring to figures showing 309,033 braceros entering in 1954, while 1,075,168 illegal entrants entered during the same year).

79. *See* CALAVITA, *supra* note 6, at 51-55; *see also* CRAIG, *supra* note 17, at 128.

80. CALAVITA, *supra* note 6, at 54 (noting that in addition to illegal entrants, the INS was accused of deporting legal residents and even United States citizens of Mexican descent); *see also* CRAIG, *supra* note 17, at 128.



throughout the Southwest.<sup>81</sup> Critical to its success was the effective use of the media by the INS to scare away many more illegal entrants than could have been apprehended.<sup>82</sup> In the end, the INS viewed Operation Wetback as a great success.<sup>83</sup> The tide of illegal entrants decreased dramatically,<sup>84</sup> while the numbers of Bracero workers steadily climbed.<sup>85</sup>

The trend of increased importation of Bracero laborers would continue. It is estimated that 2.5 million Mexican Braceros were employed in the United States between 1954 and 1959.<sup>86</sup> Within these six years, over \$200 million was withheld from Mexican Braceros' paychecks and sent to the Mexican government, which held the money for the workers.<sup>87</sup> Given the importance of the program to the Mexican economy, the Mexican government during this time became less involved with negotiating new terms and summarily accepted requests to renew the program.<sup>88</sup>

4. *The Eventual Demise of the Program.*—The Bracero Program had been extended by various measures and remained operative until the end of 1963.<sup>89</sup> However, the election of John F. Kennedy as President marked a shift in the political dynamic. President Kennedy desired substantial revisions to the program to protect domestic farm workers.<sup>90</sup> Moreover, the horrible working and housing conditions of agricultural workers had been brought to light in 1960 by a CBS documentary entitled "Harvest of Shame."<sup>91</sup>

Although unable to achieve by legislation many of the changes demanded, the Kennedy administration was able to regulate the program better through decisions by the Department of Labor. In 1962, the Secretary of Labor began

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81. CRAIG, *supra* note 17, at 129.

82. CALAVITA, *supra* note 6, at 54.

83. *Id.*

84. CRAIG, *supra* note 17, at 129 (referring to statistics that show the number of illegal entrants declining in 1955 to less than 250,000; in 1956, less than 73,000; and, by 1960, less than 30,000).

85. CALAVITA, *supra* note 6, at 55 (showing the number of braceros increasing from 201,380 in 1953; to 398,650 in 1955; and 445,197 in 1956).

86. CRAIG, *supra* note 17, at 130; *see also* CALAVITA, *supra* note 6, at 218 (citing CONG. RESEARCH SERV., *supra* note 35, at 65).

87. CRAIG, *supra* note 17, at 130.

88. *Id.* at 137-38 (explaining that income from Bracero remittances ranked third during these years behind tourism and cotton production).

89. *See id.* at 155-74.

90. *See id.* at 164, 174-75.

91. *See* LINDA C. MAJKA & THEO J. MAJKA, FARM WORKERS, AGRIBUSINESS, AND THE STATE 160 (1982). Due to the widespread exploitation experienced by most of the program's invitees, today the name Bracero has become synonymous with indentured servitude. *See* H.R. REP. NO. 99-682(I), at 83-84 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5649, 5687-88; *see also* H.R. REP. NO. 106-982(I), at 53 (2000) (stating that the documentary "exposed abuses by the growers, including unpaid wages, poor housing, and the physical toll of 'stoop labor'").

enforcing a new wage rate.<sup>92</sup> Previously, growers were only required to pay the prevailing wage rate of their area, but now the Secretary would require them to pay an adverse-effect wage rate (AEWR) based on the entire state.<sup>93</sup> Such an AEWR was derived from a government study of farm workers.<sup>94</sup> This requirement effectively forced growers to pay more than before to both domestic and Bracero workers.<sup>95</sup>

The move by the Secretary of Labor dramatically reduced the number of growers willing to continue using Bracero workers.<sup>96</sup> At the same time, mechanization of the cotton crop, which previously warranted the use of significant Mexican laborers, created less of a demand for human laborers.<sup>97</sup> Thus, from 1960 until 1964, the use of Bracero workers decreased each year.<sup>98</sup> Further actions by Congress signaled the end of the contentious program, which had been responsible for importing over four million Mexican workers between 1942 and 1964.<sup>99</sup> In 1963, one final extension of the Bracero Program was passed by Congress, thus prolonging the program's existence until December 31, 1964.<sup>100</sup> Growers were put on notice that no more extensions would be granted.<sup>101</sup> While begrudgingly accepting the demise of the Bracero Program, their focus shifted instead to finding a new source of laborers.

### *C. The H-2 Program: 1952-1986*

In 1952, as part of the Immigration and Nationality Act of 1952,<sup>102</sup> Congress passed legislation creating the H-2 program.<sup>103</sup> At first, the program did not receive much attention because of the existence of the Bracero Program.<sup>104</sup> However, as that program expired in 1964, growers focused on the H-2 Program and how to use it to continue the labor trends established under the Bracero

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92. CRAIG, *supra* note 17, at 178-80.

93. *Id.* at 179. Administrative authority of this kind recently had been upheld by a federal district court. *See Dona Ana County Farm & Livestock Bureau v. Goldberg*, 200 F. Supp. 210 (D.D.C. 1961).

94. CRAIG, *supra* note 17, at 180-81.

95. *Id.* at 180.

96. *See id.* at 180-81.

97. *See id.*

98. In 1960, there were 315,846 Braceros (down from 437,543 in 1959); in 1961, 291,420; in 1962, 194,978; in 1963, 186,865; and in 1964, 177,736. CALAVITA, *supra* note 6, at 218 (citing CONG. RESEARCH SERV., *supra* note 35, at 65).

99. *See id.* (citing CONG. RESEARCH SERV., *supra* note 35, at 65).

100. CRAIG, *supra* note 17, at 195.

101. *See id.* at 196.

102. *See supra* note 73 and accompanying text for further context.

103. The H-2 Program, unlike the Bracero Program, was not limited to agricultural employment. Gail S. Coleman, *Overcoming Mootness in the H-2A Temporary Foreign Farmworker Program*, 78 GEO. L.J. 197, 202 (1989).

104. *See Semler, supra* note 74, at 194.



Program.<sup>105</sup> Yet the Department of Labor had other plans for the H-2 program, including effectuating the eventual elimination of reliance on foreign workers.<sup>106</sup> These differing views for the future of the H-2 Program led to a showdown in the U.S. Senate.<sup>107</sup>

In 1965, as regulations were promulgated concerning the H-2 Program, a struggle emerged in the Senate regarding who was best fit to determine whether, in fact, foreign workers were necessary based on a U.S. labor shortage.<sup>108</sup> Growers, who wanted easy access to workers, suggested that the more lenient Secretary of Agriculture should make such a determination; on the other hand, the administration wanted the more stringent Secretary of Labor to be responsible for such certification.<sup>109</sup> In the end, the Senate was evenly divided, and Vice President Hubert Humphrey cast the deciding vote, resulting in the Secretary of Labor having determination-making authority.<sup>110</sup> “Bolstered” by this affirmation of his authority, the Secretary of Labor responded by terminating the use of Mexican labor in the United States for agriculture.<sup>111</sup> However, continued admissions of H-2 workers were allowed for two agricultural industries—Northeast apple orchards and Florida sugarcane.<sup>112</sup> The arrangement allowing for limited importation of H-2 workers for the sugarcane and apple industries continued until 1976.<sup>113</sup> Shortly thereafter, requests for Mexican workers in different crops were first certified.<sup>114</sup>

Similar to previous foreign labor programs, growers had to show a lack of sufficient labor in the United States to import H-2 workers.<sup>115</sup> Further, the importation of foreign workers could not adversely impact similarly employed U.S. workers.<sup>116</sup> The best way for the Department of Labor to prevent such a negative affect was by setting an adverse-effect wage rate (AEWR), an area-by-area minimum wage paid to each H-2 worker.<sup>117</sup> Additionally, employers of H-2 workers had to provide free housing to their U.S. workers<sup>118</sup> and pay travel advances to U.S. workers if also provided for foreign workers.<sup>119</sup> The H-2

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105. *See id.*

106. *See* 29 Fed. Reg. 19101, 19101 (Dec. 30, 1964).

107. Semler, *supra* note 74, at 195.

108. *See id.* at 195-96.

109. *See id.*

110. *See id.* at 196.

111. *Id.*

112. *Id.*

113. *See id.* at 196-97, 200-04.

114. *See id.* at 204.

115. *See* 8 C.F.R. § 214.2(h)(3)(i) (1982).

116. *Id.*

117. *See* Labor Certification Process for Temporary Agricultural and Logging Employment, 20 C.F.R. §§ 655.200(b), 655.207 (1982).

118. 20 C.F.R. § 655.202(b) (1982).

119. 20 C.F.R. § 655.202(a) (1982).

Program continued to expand<sup>120</sup> until it was replaced in 1986 by the H-2A Program.

## II. THE H-2A PROGRAM

### *A. Immigration Reform and Control Act of 1986*

The Immigration Reform and Control Act of 1986 (IRCA) continued the various immigration reforms.<sup>121</sup> Three main aspects of the Act specifically addressed issues affecting migrant farm workers: the employer sanctions provisions, the legalization programs offered to promote farm work, and the revisions made to the H-2 Program. Each aspect will be discussed separately.

1. *Employer Sanctions.*—"The employer provisions of [the] IRCA prohibit[ed] three types of activity: (1) the knowing hiring of unauthorized aliens; (2) the continued employment of known unauthorized aliens; and (3) the hiring of any individual without verifying identity and authorization to work . . ."<sup>122</sup> Amazingly, this marked the first time in U.S. history that employers of undocumented workers would be penalized by the government.<sup>123</sup> The sanctions could take one of two forms: civil fines or criminal charges.<sup>124</sup> Not surprisingly, growers became concerned that cutting off their ability to hire undocumented farm workers would extinguish their labor supply.<sup>125</sup> As one author put it, "If employer sanctions were to be instituted under the proposed legislation, growers wanted some assurance that they lawfully could obtain sufficient numbers of workers."<sup>126</sup> Thus, another part of the legislation provided growers with a supply of domestic labor.

2. *Legalization Programs.*—As part of IRCA, Congress created an amnesty program, which offered to legalize the migrant farm worker labor pool.<sup>127</sup> Under the terms of the program, known as the Special Agricultural Worker (SAW) program, any undocumented worker (up to 350,000 total) that had completed ninety days of work in seasonal agricultural work during each of the previous

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120. Semler, *supra* note 74, at 205.

121. Pub. L. No. 99-603, 100 Stat. 3359 (1986) (codified as amended in scattered titles and sections of U.S.C.).

122. MICHAEL FIX & PAUL T. HILL, ENFORCING EMPLOYER SANCTIONS 32 (1990).

123. The Mexican government made requests in the 1950s to penalize employers for exactly this type of activity, but they were to no avail. See CRAIG, *supra* note 17, at 126.

124. See FIX & HILL, *supra* note 122, at 34.

125. See Stephen Yale-Loehr, *Foreign Farm Workers in the U.S.: The Impact of the Immigration Reform and Control Act of 1986*, 15 N.Y.U. REV. L. & SOC. CHANGE 333, 335 (1988).

126. *Id.*

127. The migrant farm worker amnesty program should not be confused with the "general amnesty" or registry program also offered by the IRCA. Under that program, any illegal alien who had continuously resided in the United States since before January 1, 1982, could apply for permanent residency. See 8 U.S.C. § 1255a (1994 & Supp. V 1999).



three years would be eligible to gain lawful permanent residency.<sup>128</sup> Those who did not meet these requirements, but had worked at least ninety days during the previous year, would gain permanent residency, but would have to wait additional time.<sup>129</sup>

In the event these SAW workers were to leave agricultural work after gaining lawful status, the IRCA provided for the Replenishment Agricultural Worker (RAW) program.<sup>130</sup> Under this program, workers could be brought in only during a three-year span (1990 to 1993) and only if there was a certified labor shortage.<sup>131</sup> Additionally, if RAW workers wanted to maintain their lawful status, they would have to continue to work in agriculture for at least ninety days for each of the three years after their entry.<sup>132</sup> However, these were not the only means by which growers were insured a continued labor supply.

3. *H-2A Program Creation.*—In addition, the IRCA made significant alterations to the H-2 Program, thereby providing a further source of immigrant labor for agricultural employers. The new law divided the H-2 program into two separate programs: the H-2A Program (for importation of temporary, foreign, *agricultural* workers) and the H-2B Program (for importation of temporary, foreign, *non-agricultural* workers).<sup>133</sup> The H-2A Program essentially is the same today as it was upon its creation in 1986.

### B. H-2A Program Specifications

Under the current H-2A Program statutory requirements, the Attorney General may not approve a petition requesting foreign agricultural workers unless the petitioner has requested a certification from the Department of Labor.<sup>134</sup> That certification must state that

- (A) there are not sufficient workers who are able, willing, and qualified, and who will be available at the time and place needed, to perform the labor or services involved in the petition, and
- (B) the employment of the alien in such labor or services will not adversely affect the wages and working conditions of workers in the United States similarly employed.<sup>135</sup>

Further, the Department of Labor is prohibited from certifying a labor shortage

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128. *Id.* § 1160(a) (1994); see also CALAVITA, *supra* note 6, at 168.

129. See 8 U.S.C. § 1160(a).

130. See CALAVITA, *supra* note 6, at 168; see also 8 U.S.C. § 1161(a)(1) (1988) (repealed 1994).

131. See 8 U.S.C. § 1161(a).

132. See Yale-Loehr, *supra* note 125, at 364 (noting also that to become a U.S. citizen, RAWs would have to work five years in agriculture after entry).

133. *Id.* at 335-36.

134. 8 U.S.C. § 1188(a) (1994).

135. *Id.*

if any of the following conditions exist: there is a labor dispute in progress; there have been previous violations of H-2A worker agreements; no workers' compensation insurance is provided; or

[t]he Secretary determines that the employer has not made positive recruitment efforts within a multi-state region of traditional or expected labor supply where the Secretary finds that there are a significant number of qualified United States workers who, if recruited, would be willing to make themselves available for work at the time and place needed.<sup>136</sup>

There are also regulations pertaining to the H-2A Program that mostly regulate actions by different divisions of the U.S. Department of Labor.<sup>137</sup> Under certain regulations, the Employment and Training Administration of the Wage and Hour Division must ensure that job offers to potential H-2A workers include the following: workers' compensation coverage, free housing, three-quarters guarantee (i.e., that there will be work for at least three-quarters of the contract period), provision for three daily meals or equipment to prepare meals, free tools where common practice, and free transportation between work site and living quarters (as well as reimbursement of transportation costs from country of origin after completing at least fifty percent of the work contract).<sup>138</sup> Additionally, an AEWR must be paid to all U.S. based and H-2A workers.<sup>139</sup> The purpose of the AEWR is to set a minimum wage in a given area so that the wages of domestic workers in that same area will not be negatively impacted by the importation of foreign workers.<sup>140</sup> Finally, an employer must provide employment to any qualified U.S. worker applying for the same job for which an H-2A worker has been hired until fifty percent of the work contract has elapsed.<sup>141</sup>

### III. PROPOSED LEGISLATION AFFECTING THE H-2A PROGRAM

In 2000, as in recent years,<sup>142</sup> several bills were introduced in Congress that would have substantially altered the configuration of the H-2A Program. One of the bills, the Agricultural Opportunities Act,<sup>143</sup> introduced on May 25, 2000, would have eliminated the need for the current H-2A Program all together. In its

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136. *Id.* § 1188(b).

137. *See, e.g.*, 8 C.F.R. § 214.2(h) (2001); 20 C.F.R. §§ 651.10, 655.0-655.00, 655.09-655.114; 29 C.F.R. § 501.0-501.47 (2000).

138. *See* 20 C.F.R. § 655.102(b) (2001).

139. *See id.* § 655.100(b).

140. *See id.*

141. *Id.* § 655.103(e).

142. *See, e.g.*, H.R. 3410, 105th Cong. (1998); H.R. 2377, 105th Cong. (1997); *see also* H.R. 1327, 107th Cong. (2001) (requiring all lawsuits brought by H-2A workers against an employer be brought "in the State in which the employer resides or has its principal place of business").

143. H.R. 4548, 106th Cong. (2000).



place, the author of the bill, Representative Richard W. Pombo of California, would have created a new H-2C Program.<sup>144</sup> The other series of bills would have significantly changed the structure of the current H-2A Program.

### *A. Registry Legislation*

Several differences exist between the Pombo proposal and the current H-2A Program. The starkest difference would have been the creation of a central registry of readily available domestic workers to agricultural employers, maintained by the U.S. Department of Labor.<sup>145</sup> Thus, whenever a U.S. grower sought foreign agricultural laborers, that employer would first have been required to request domestic employees from the registry.<sup>146</sup> If there were an insufficient number of workers produced from the search of the registry, then the grower would have been able to petition for H-2C workers to fill the employment vacancies.<sup>147</sup> There would have been no additional recruitment requirements that the grower would have to satisfy before being granted permission to hire foreign workers.

Additional changes pertain to requirements that an employer of the H-2C workers would have been required to meet in order to receive and maintain H-2C workers. As is the case with the H2-A program, an employer would have had to pay each worker the greater of an AEWR or the prevailing wage rate.<sup>148</sup> However, the definition of AEWR would have been changed to mean generally the prevailing wage rate of the area plus a five percent increase.<sup>149</sup> Second, the original bill provided that a housing allowance could be provided to the H-2C workers, for the first three years after the bill takes effect, in lieu of actual housing arrangements; yet, that change was subsequently altered by the Judiciary Committee to require that housing be provided unless the Governor of that state certifies that adequate housing is available in the area.<sup>150</sup> Finally, absent from the Pombo bill, but later added by the Judiciary Committee, was a requirement that guaranteed three-quarters of the work days to a recruited employee similar to the three-quarters guarantee as found in the H-2A Program.<sup>151</sup>

### *B. Adjustment Legislation*

A combination of other bills would substantially alter the existing H-2A

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144. *See id.* § 2(4)-(5).

145. *See id.* § 101(a)(1).

146. *See id.* § 101(a)(4).

147. *See id.* § 202-03.

148. *See id.* § 204(a); *cf.* Susan LaPadula Buckingham, Note, *The DOL Fails U.S. and Foreign Laborers with New AEWR Methodology*, 4 GEO. IMMIGR. L.J. 477 (1990) (explaining history of AEWR methodology and that twenty percent enhancement, used before IRCA, was unjustly taken away by DOL regulations).

149. *Compare* H.R. 4548, § 2(1) *with* 20 C.F.R. § 655.100(b) (2001).

150. *Compare* H.R. 4548, § 204(b)(6) *with* H.R. REP. NO. 106-982(I), at 9-10 (2000).

151. *See* H.R. REP. NO. 106-982(I), at 11.

Program instead of replacing it with an entirely new program. The main bill, H.R. 4056,<sup>152</sup> would have created a lawful residency program for those who were unlawfully present in the United States and working in agriculture for at least 880 hours (or 150 days) during the year prior to March 31, 2000.<sup>153</sup> These previously undocumented immigrants would have initially been granted nonimmigrant and nonpermanent status for up to seven years.<sup>154</sup> Within those seven years, the immigrant would have had to continue to work for at least 180 days in agriculture for a minimum of five years before being eligible for lawful permanent resident status.<sup>155</sup> Once these nonimmigrant laborers have obtained the necessary work quota and have petitioned for permanent residency, there would have been a limitation on the issuance of visas.<sup>156</sup> There would have been a cap of twenty percent of all those eligible to apply per year, with priority based on accumulated work hours.<sup>157</sup> Thus, some laborers would have had to wait five years or more after completing their work requirement before being granted their permanent status (and the ability to petition for their families who must otherwise remain abroad).

Additional modifications made by H.R. 4056 include changes similar to those found in the Pombo bill. The general definition of the AEWR that the new H-2A workers would have to be paid would have been changed to a five percent increase above the prevailing wage rate in any given area.<sup>158</sup> The bill made no provision for the required recruitment of U.S. workers beyond searching for those workers who have applied to a job registry.<sup>159</sup> A housing allowance could have been paid to workers instead of providing housing.<sup>160</sup> Finally, unlike the final version of H.R. 4548, H.R. 4056 did not guarantee that H-2A workers would be paid for at least three-quarters of the contract period.

### *C. Compromise Legislation*

Just before the conclusion of the 106th session of Congress, a compromise bill had been reached among members from the Senate and the House of Representatives that would have revamped the H-2A Program and provided earned adjustment of status for undocumented migrant farm workers.<sup>161</sup>

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152. 106th Cong. (2000); *see also* S. 1815, 106th Cong. (1999); S. 1814, 106th Cong. (1999).

153. *See* H.R. 4056, § 101(a)(1)(A).

154. *See id.* § 101(a).

155. *See id.* § 101(b).

156. *See id.* § 101(b)(5).

157. *See id.*

158. *See id.* § 1(A).

159. *See id.* § 201(a).

160. *See id.* § 304(b)(6). Starting three years after enactment, the Governor of the relevant state would have had to certify the availability of sufficient housing. *Id.*

161. Michael Doyle, *Senator Leader Blocks Guestworker Deal*, FRESNO BEE, Dec. 16, 2000, at A25.



However, at the last minute, the Senate leadership withdrew the compromise.<sup>162</sup> The compromise would have had two major components.

The first portion of the compromise package would have provided an earned adjustment program for undocumented agricultural workers.<sup>163</sup> Similar to that under the Immigration Reform and Control Act of 1986, if workers completed one hundred days of work in agriculture during the year prior to the bill's enactment, they would have been eligible to apply for the legalization program.<sup>164</sup> Unlike the IRCA, they would have been required to continue to work in agriculture until they had completed 360 days of work within the six year period following the bill's enactment.<sup>165</sup>

The second portion would have modified the H-2A Program. One change would have allowed growers to provide a housing allowance instead of actual housing, where the governor of the state certified that there was adequate housing in the given area.<sup>166</sup> Additionally, the current AEWR would have been frozen until 2004, following a study of its methodology.<sup>167</sup> Finally, procedures at the U.S. Department of Labor would have been streamlined to make the program easier for growers to access.<sup>168</sup>

#### *D. Senator Gramm's Recent Comments*

On January 11, 2001, U.S. Senator Phil Gramm of Texas, one of the leading critics of the compromise legislation just discussed, released a fact sheet entitled "How a U.S.-Mexico Guest Worker Program Might Function."<sup>169</sup> It was produced after discussions with Mexican President Vicente Fox. The goals outlined include "fair treatment, including protection under the law, for Mexican

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162. *See id.*

163. *See id.*

164. Managing Attorney Rob Williams of Florida Legal Services, Presentation at National Legal Aid & Defender Association Conference (Nov. 30, 2000). Williams represented the United Farm Workers (UFW) union in the negotiations of the compromise legislation. Notes from the presentation made by the author are in his possession. More specifics about the compromise are not included herein as a copy was not made available to the public.

165. *See id.*

166. *See id.* However, even a housing allowance would not be enough to satisfy the American Farm Bureau Federation (AFBF), which would like to see H-2A employers given Section 8 housing vouchers by the U.S. Department of Housing and Urban Development. For a policy statement by the AFBF on H-2A housing issues and other H-2A Program changes, see Am. Farm Bureau, *Immigration—Reform of the H-2A Program* (Sep. 2001), <http://www.fb.org/issues/backgrd/immigrat107.html>.

167. By regulation, the adverse effect wage rate must be published in the Federal Register "at least once in each calendar year." 20 C.F.R. § 655.107(a) (2001).

168. Williams, *supra* note 164.

169. <http://www.senate.gov/~gramm/press/guestworker.html>. Recently, Senator Gramm announced his intention to retire from the U.S. Senate in 2002.

citizens who live and work in the United States.”<sup>170</sup> Gramm’s initial operational objectives were to secure the border from an influx of illegal immigrants; create a “workable” employment program tied annually to the U.S. unemployment rates, for Mexican workers that would require them to return to Mexico after completion of their work; and increased penalties for the employment of undocumented workers.<sup>171</sup>

Since Senator Gramm’s comments in January, there has been an increase in press coverage of the H-2A Program.<sup>172</sup> The debate centers around whether those being given immigrant status to work in the United States should also be given the right to permanently reside in the United States after completing the requisite farm work.<sup>173</sup> Advocates for immigrants believe they should, while those on the growers’ side believe the opposite. Senator Gramm sides with the growers.<sup>174</sup> This issue should be decided in the near future.<sup>175</sup>

#### IV. POLICY CONCERNS

##### A. Current H-2A Program Concerns

1. *Is There a Labor Shortage?*—The potential existence of a labor shortage is one of the most heated debates surrounding the H-2A program. Growers continually argue that the short supply of labor for agricultural entities necessitates recruiting foreign workers as the H-2A Program would facilitate.<sup>176</sup> The argument has two components. First, growers argue they cannot find enough workers. Second, growers assert that even if they could find workers, they would be overwhelmingly undocumented and susceptible to immigration raids, leaving the growers with no one to pick their crops.<sup>177</sup> However, as one explores these

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170. *Id.*

171. *Id.*

172. *See, e.g.,* Ruben Navarrette, *Immigration Policy Can Make Strange Bedfellows*, INDIANAPOLIS STAR, Apr. 19, 2001, at A13.

173. *Id.*

174. *Id.*

175. Just before the tragic attacks on September 11, 2001 in the United States, President Vicente Fox of Mexico visited with U.S. President George W. Bush in Washington, D.C. to discuss the issue of a “regularization” program for Mexican workers in the United States. Little has been mentioned since September 11 about these efforts. No one is certain how long it will take for Congress to take up the issue of Mexican immigration to the United States.

176. *Agricultural Opportunities Act: Hearing on H.R. 4548 Before the Subcomm. on Immigration and Claims of the House Comm. on the Judiciary*, 106th Cong. 112 (2000) (statement of Dewey Hukill for Texas Farm Bureau) (“Many Texas growers are beginning to find that labor available [sic] related problems are taking more of their management time. This is happening in the state that at one time boasted a bountiful farm and ranch labor work force.”).

177. PHILIP MARTIN, GUEST WORKERS FOR AGRICULTURE: NEW SOLUTION OR NEW PROBLEM? (Ctr. For German & European Studies, Univ. of Cal., Berkeley, Working Paper 4.8, 1996) (referencing grower arguments from Congressional hearings occurring in 1995 on proposed foreign



claims, the short-sightedness of the position becomes apparent.<sup>178</sup>

As to whether there is a labor shortage, under the terms of the H-2A Program statute, growers seeking foreign workers are first required to recruit domestic workers in their traditional place of residence.<sup>179</sup> Yet, in practice, the Department of Labor often will not require that growers recruit workers outside of their region. If an Indiana grower cannot locate an adequate number of workers within his local area and wishes to employ H-2A workers, he might only be required to perform a positive search within the nearby region of states such as Illinois, Ohio, and Michigan. However, these states likely are experiencing the same local shortage of workers as Indiana because, generally, the source for Midwest farm workers does not come from the region itself, but from base states such as Texas.<sup>180</sup> Had the Indiana grower been required to seek domestic workers directly from the base states, he would likely have found an abundance of workers because in most of these states, unemployment rates soar to double digits even in recent times of relative economic growth.<sup>181</sup>

The statute demands positive recruitment from sources likely to produce results, yet, the Department of Labor, perhaps in an effort to not appear too bureaucratic, has formed its own seemingly contradictory interpretation. The H-2A Program's statutory requirements should be strictly construed. It should not be up to the Department of Labor, which changes with each administration, to opine about what positive recruitment should be required of growers seeking to hire H-2A workers. Further, the statute clearly states that the positive recruitment requirement is "in addition to, and shall be conducted within the same time period as, the circulation through the interstate employment service system of the employer's job offer."<sup>182</sup> Thus, it is insufficient to place the job order on a series of states' employment service systems or America's Job Bank in order to satisfy the positive recruitment requirement. The statute explicitly requires more.<sup>183</sup>

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agricultural worker programs).

178. As to the effects from the increased use of undocumented workers, more will be discussed on this issue, see *infra* Part V.A.3.b.

179. See *supra* note 136 and accompanying text.

180. See STEPHEN H. SOSNICK, HIRED HANDS: SEASONAL FARM WORKERS IN THE UNITED STATES 10-14 (1978). Base states are called such because they are the bases from which workers flow in the migrant stream northward. The largest include Texas, Florida, and California.

181. H.R. REP. NO. 106-982(I) (2000) (citing the National Agricultural Workers Survey); see also H-2A AGRICULTURAL GUESTWORKERS: STATUS OF CHANGES TO IMPROVE PROGRAM SERVICES, at 4 (2000) (GAO/T-HEHS-00-134) [hereinafter STATUS] (explaining that the "national unemployment rate for hired farmworkers has remained above 10 percent since 1994, has increased since 1997, and at 11.8 percent in 1998, has remained well above the national average").

182. 8 U.S.C. § 1188(b)(4) (1994).

183. Additionally, regulations for the Department of Labor state, "The [Regional Administrator] shall ensure that the effort, including the location(s) of the positive recruitment required of the potential H-2A employer . . . shall be no less than . . . the *kind* and *degree* of recruitment efforts which the potential H-2A employer made to obtain H-2A workers." 20 C.F.R.

As to the argument that the INS will target agricultural operations for undocumented workers and thereby create a shortage of available workers, the INS has itself debunked this claim.<sup>184</sup> Because of its limited resources, the INS must focus its efforts on higher priorities such as criminally convicted "aliens," rather than agricultural workers.<sup>185</sup> Thus, it does not seem that growers' fears about INS raids on their farms are well-founded.

2. *Indentured Servitude*.<sup>186</sup>—H-2A workers are required to work only for their petitioning employers. Under INS regulations, employment "authorization only applies to the specific employment indicated in the relating petition, for the specific period of time indicated."<sup>187</sup> The workers are not entitled to work for any other employer if discharged. Once they cease employment with the petitioning employer, they immediately become undocumented and are illegally in the country.<sup>188</sup> Further, the employer of H-2A workers fired for cause will "not be responsible for providing or paying for the subsequent transportation and subsistence expenses of [that] worker . . . and that worker is not entitled to the 'three-quarters guarantee' . . . ."<sup>189</sup>

Unfortunately, because H-2A workers are literally tied to a certain agricultural employer, the current regulations could easily lead to program abuse by unscrupulous growers. Suppose an H-2A employee complains about hazardous or potentially illegal working conditions to his employer. That worker could be easily intimidated or discharged (work standards may be written in a rather ambiguous and subjective manner to facilitate such illegal retaliations). Once the H-2A employee is discharged "for cause," then the INS is notified and the employee is forced unjustly to leave the country without the benefit of free transportation or the guaranteed work wages. Unable to explain himself sufficiently in the English language, this unjust act goes completely unknown and therefore unpunished.

Because of the vulnerable position of H-2A workers, strong enforcement of the program requirements is necessary to discourage the kind of abuses demonstrated above and to ensure that program standards are being met.<sup>190</sup> The

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§ 655.105(a) (2001) (emphasis added). Hence, if a grower hires a farm labor contractor to find H-2A workers in Mexico, then the same effort should be required in the search for domestic workers.

184. H-2A AGRICULTURAL GUESTWORKER PROGRAM: CHANGES COULD IMPROVE SERVICES TO EMPLOYERS AND BETTER PROTECT WORKERS, at 2 (1998) (GAO/T-HEHS-98-200) [hereinafter CHANGES].

185. *Id.*

186. For constitutional arguments based on the doctrine of involuntary servitude, see Kimi Jackson, *Farmworkers, Nonimmigration Policy, Involuntary Servitude, and a Look at the Sheepherding Industry*, 76 CHI.-KENT L. REV. 1271, 1288-92 (2000).

187. 8 C.F.R. § 214.2(h)(5)(viii)(B) (1997).

188. *Id.* § 214.2(h)(5)(vi)(A) (pertaining to duty of H-2A employer to notify INS within twenty-four hours after an H-2A worker absconds).

189. 20 C.F.R. § 655.102(b)(11) (1997).

190. See 132 CONG. REC. 30183 (1986) (comments of Rep. Berman of California) ("H-2 workers would be entitled if they otherwise qualified . . . to legal services representation, because



federal government, through the enforcement branch of the Department of Labor, attempts to enforce these laws the best it can; however, by the admission of a senior administrator, it is unable to meet all the demands made upon it by the H-2A program under current funding levels.<sup>191</sup> For this reason, additional enforcement mechanisms and entities must be utilized. One such group involved with supplemental enforcement of H-2A regulations is the Migrant Legal Service programs.

Programs funded by the Legal Services Corporation (LSC) specifically allow representation of H-2A workers only with legal issues arising from their work agreements.<sup>192</sup> However, a previously undefined sentence fragment in the corporation's appropriations act led some critics to raise questions about whether legal service programs should be allowed to represent an alien who is no longer present in the United States.<sup>193</sup> Because of concerns raised by this complaint, the corporation appointed the Erlernborn Commission to determine the Congressional intent of the undefined "presence in the United States" requirement. The commission sought public comment on the issue.<sup>194</sup> In the end, the commission determined that "[f]or H-2A workers, representation is authorized if the workers have been admitted to and have been present in the United States pursuant to an H-2A contract, and the representation arises under their H-2A contract."<sup>195</sup> Thus, as long as the H-2A worker seeking representation was at one time present in the United States under the work contract on which the suit is based, then LSC-funded legal service programs permit representation that worker.<sup>196</sup>

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without that, the protections contained for those workers, the housing protections, the domestic, the transportation protections, the piecework rate and adverse impact wage rates protections become utterly meaningless.").

191. See *Agricultural Opportunities Act: Hearing on H.R. 4548 Before the Subcomm. on Immigration and Claims of the House Comm. on the Judiciary*, 106th Cong. 44 (2000) (statement of John R. Fraser, Deputy Administrator, Wage and Hour Division, U.S. Dep't of Educ.). As a recommendation, Mr. Fraser stated:

Congress should support increased resources for stronger enforcement of U.S. labor laws. Increased funding and Congressional support for strong labor law enforcement will ensure that the Department can effectively focus on and deploy adequate resources to address those employers which pay less than legal wages and provide substandard work environments.

*Id.*

192. 45 C.F.R. § 1626.11 (2001). Aside from permitting representation of H-2A workers, LSC-funded programs prohibit the representation of any other nonimmigrant alien (except for victims of domestic violence in certain circumstances).

193. Complaint filed with the Legal Services Corporation against the Georgia Legal Services Corporation by, inter alia, the National Legal and Policy Center (Mar. 17, 2000), <http://www.nlpc.org/lsap/complaints/000317ga.htm> (arguing that an LSC-funded program should not be able to represent H-2A workers who are no longer "present" in the United States).

194. 64 Fed. Reg. 8140, 8141 (Feb. 18, 1999).

195. ERLERNBORN COMMISSION REPORT at 58 (2000).

196. However, such complaints demonstrate the tactics certain pro-grower groups will resort

3. *Discrepancy of Benefits*.—A strange phenomenon occurs as a result of the federal regulations surrounding the H-2A Program: *foreign* agricultural workers will be provided with employment benefits that the *domestic* work force is not entitled to receive. This effect occurs in several areas of the law.<sup>197</sup>

The H-2A statute mandates that employers provide workers' compensation coverage for all workers, including H-2A workers.<sup>198</sup> In many states, including Indiana, workers' compensation coverage is not required for agricultural workers.<sup>199</sup> Thus, if an employer in Indiana were to hire H-2A workers, he would be required to provide workers' compensation coverage, under the federal regulations, for those workers (and for domestic workers hired under the same employment contract); however, domestic employees working for the same employer on a different type of job would be exempt from workers' compensation coverage. Unfortunately, the disparate treatment does not end there.

The H-2A Program guidelines also require certain benefits for the foreign workers, including free housing, transportation reimbursements, three-quarters work guarantee, AEWR, and three meals provided per day or access to a facility in which to cook meals.<sup>200</sup> One would assume, logically, that the same employer would have to offer similar benefits to his domestic population, regardless of whether it is working in the same type of job as the H-2A workers. Unfortunately, if the job order under which the H-2A workers are working (e.g., picking cantaloupes) is sufficiently distinguishable from positions in which domestic workers are working, (e.g., picking watermelons), then the same employer need not provide the same types of benefits to all workers.<sup>201</sup> Hence, the employer could charge some of the domestic workers for meals, housing, and transportation, while having to provide the same exact benefits to H-2A workers free of charge. Also, the employer legally can pay the domestic workers

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to in order to prevent H-2A Program violations from being detected and redressed.

197. See, e.g., *Reyes-Gaona v. N.C. Growers Ass'n*, 250 F.3d 861 (4th Cir. 2001) (holding that the Age Discrimination Employment Act does not apply to the hiring of H-2A workers outside the United States), *cert. denied*, 122 S. Ct. 463 (2001); *Farmer v. Employment Sec. Comm'n of N.C.*, 4 F.3d 1274 (5th Cir. 1993) (addressing a conflict of laws between the H-2A Program housing provisions and the prohibitions against discrimination based on familial status of Title VIII of the Civil Rights Act of 1968).

198. 8 U.S.C. § 1188 (b)(3) (1994).

199. *Collins v. Day*, 644 N.E.2d 72 (Ind. 1994) (holding that agricultural worker exemption from workers' compensation coverage does not violate the Equal Privileges clause of the Indiana Constitution). Other states that generally exclude agricultural workers from mandatory workers coverage include: Alabama, Arkansas, Kansas, Kentucky, Mississippi, Nebraska, Nevada, New Mexico, North Dakota, Rhode Island, South Carolina, and Tennessee. See SHELLEY DAVIS, INCREASING FARMWORKERS' ACCESS TO WORKERS COMPENSATION BENEFITS at 17 (1999).

200. 20 C.F.R. § 655.102(b) (2001); see also Part II.B, *supra*.

201. See Letter from Sarah Carroll, Regional Certifying Officer, Employment & Training Admin., U.S. Dep't of Labor, to Tish Sowards, Regional Director, Int'l Labor Mgmt. Corp. (May 24, 2000) (on file with author).



significantly less per hour than the H-2A workers.<sup>202</sup> Finally, the domestic worker is not guaranteed to receive wages for at least three-quarters of the work promised to him, as is the H-2A worker.

On the other hand, domestic workers have a better employment situation than H-2A workers. The Migrant and Seasonal Agricultural Worker Protection Act (AWPA) creates several obligations on the part of any employer utilizing domestic agricultural workers.<sup>203</sup> Included among these obligations are duties for recruiting, transporting, housing, and employing migrant and seasonal farm workers. If any duty is breached, the violating party may be held liable in a private action brought by the offended worker(s) for up to \$500 per violation per worker.<sup>204</sup> The law is designed to deter similar violations in the future by private enforcement.<sup>205</sup> However, H-2A workers were specifically excluded from the protection of AWPA.<sup>206</sup> Thus, in order for an H-2A worker to bring a claim against a breaching employer, he must generally bring a state suit under a contract law theory.<sup>207</sup>

Such outcomes are inherently unjust. Regulations should be promulgated by the Department of Labor to ensure that all workers receive the same compensation for performing essentially the same type of farm work. If the Department of Labor does not act, then it is incumbent upon Congress to prevent such an unjust result from continuing.

Just because domestic workers are entitled to some benefit that H-2A workers are not should not be seen as a victory for domestic workers. Instead it should be viewed as a failure for the H-2A workers. Economic success for domestic workers will come only through positive Congressional action as

202. The 2000 federal minimum wage that the domestic worker is required to receive was \$5.15 per hour, 29 U.S.C. § 206(a)(1); yet, the H-2A worker is required to receive the adverse effect wage rate, which for 2000 in Indiana was \$7.62 per hour. 65 Fed. Reg. 5696, 5696 (Feb. 4, 2000). In 2001, the federal minimum wage has remained at \$5.15 per hour, 29 U.S.C. § 206(a)(1), while the AEWR has increased in Indiana to \$8.09 per hour. 66 Fed. Reg. 40298, 40299 (Aug. 2, 2001).

203. See 29 U.S.C. §§ 1801-72 (1994 & Supp. V 1999).

204. See *id.* § 1854(c)(1) (1994).

205. The AWPA is a remedial statute. See *Beliz v. W.H. McLeod & Sons Packing Co.*, 765 F.2d 1317, 1332 (5th Cir. 1985), where the court stated:

The legislative history of the Act and the decisions interpreting it make clear that the purpose of this civil remedy is not restricted to compensation of individual plaintiffs.

It is designed also to promote enforcement of the Act and thereby deter and correct the exploitive practices that have historically plagued the migrant farm labor market.

*Id.*

206. 29 U.S.C. § 1802(8)(B)(ii), (10)(B)(iii) (1994).

207. For an interesting case on suits brought by H-2A workers, see *Lopez-Aguirre v. Workman*, No. 1998-CA-001367-MR (Ky. Ct. App. Aug. 25, 2000) (holding that there is an exhaustion of remedies requirement implied within H-2A regulations requiring an H-2A employee to first file a complaint with the Department of Labor before being able to file a state contract claim), *rev'd*, No. 1998-CA-001367-MR (Ky. Ct. App. Dec. 8, 2000) (same judge, reversing case after a petition for rehearing).

discussed in Part V *infra*.

### B. Proposed Legislation Concerns

1. *Pombo Registry Proposal Concerns.*—The creation of a registry system to assist growers in their recruitment efforts is a positive development. The Clinton administration undertook similar initiatives by the implementation of America's Agricultural Labor Network or "AgNet."<sup>208</sup> AgNet is an "on-line job matching system to help connect agricultural employers and workers."<sup>209</sup> It allows growers to look for workers and workers to post their work experience. However, the critical difference between the Pombo proposed registry of workers and the AgNet would be their differing purposes. With the Pombo registry, growers would *only* have to search the registry for workers. If their search was unsuccessful, then they would be able to petition the Department of Labor for foreign agricultural workers. They would not be required to conduct any additional positive recruitment by more traditional means, such as using the services of a farm labor contractor to recruit workers personally. On the other hand, AgNet is merely another source, and not the exclusive source, of recruitment for agricultural employers.<sup>210</sup>

Given the level of education and English proficiency of most migrant farm workers,<sup>211</sup> the AgNet purpose seems to make better sense. Migrants who are alerted and have the ability to post resumes and search for jobs will be able to utilize the resource. For those who would not be able to access the computer systems in order to post their credentials, the Pombo registry would have disastrous consequences. They would be penalized when it came time for growers to recruit for employment.

Ultimately, the registry debate can be reduced to the question of who should have the burden to connect an employer to an employee in agriculture? If the growers have the responsibility of finding employees, is it not likely that they will find them wherever they are and by whatever means necessary? Otherwise growers' crops would rot in the fields. However, if the employees must link themselves to the employer, the excluded notions of migrant labor unions and collective bargaining power come into play.<sup>212</sup> The status quo under the H-2A Program is to place the burden on the growers through positive recruitment requirements. However, the Pombo bill sought to alter the status quo and place the burden to connect employee and employer on the federal government. Given

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208. See *Agricultural Opportunities Act: Hearing on H.R. 4548 Before the Subcomm. on Immigration and Claims of the House Comm. on the Judiciary*, 106th Cong. 44 (2000) (statement of John R. Fraser, Deputy Administrator, Wage and Hour Division, U.S. Dep't of Educ.) (requesting funding for this Internet-based network that the Department of Labor already has begun developing).

209. *Id.*

210. *Id.*

211. SOSNICK, *supra* note 180, at 64-66.

212. See Part V.A.2.b *infra* (discussing NLRA exclusion for agricultural workers).



the difficulties the Department of Labor has in implementing the current H-2A scheme, why did the Pombo legislation assume that efforts to connect these two groups would be any better?

The drawbacks to the Pombo bill do not stop there. The bill also eviscerated most of the worker protections found in the current H-2A Program. Among those provisions lost are free housing for foreign workers and legal representation by LSC-funded organizations.<sup>213</sup> It is true that the current H-2A Program does not operate as smoothly as all parties would like, but the answer to the problems is not to eliminate worker protections. If workers cannot use legal service programs to raise actual concerns about their working conditions, how does this lead to a better program? Surely, Congress wants workers to be able to protect themselves from overstepping by law-breaking growers. The Pombo bill ignored this reality and was extremely lopsided in favor of agricultural employers.

2. *Adjustment Legislation Concerns.*—At least with the adjustment legislation, foreign agricultural workers would have received something more substantial in return for their dedicated service to American agriculture than they would have under the Pombo bill. They eventually would have been able to become permanent, lawful U.S. residents, and later U.S. citizens if they so choose. However, their reward would come at the cost of having to commit to continue working in U.S. agriculture for at least five years.<sup>214</sup> Moreover, they would have been required to complete at least 180 days of work in each of those five years.

A problem with this legislation is that it would be extremely difficult for many agricultural workers to accumulate the required number of days of work per year to obtain lawful residency. From 1997 to 1998, farm workers worked on the average 24.9 weeks per year, and those figures have been on the decline.<sup>215</sup> To qualify under this legislation, the foreign workers would have to be able to work *more* weeks than domestic workers, and that is fallaciously assuming that the domestic workers will work seven days per week during each of those weeks. The reasonable solution would be to lower the number of days the workers should be required to work per year. Yet that leads to another potential problem.

When workers are forced to work prospectively in order to gain a benefit, the very nature of the workers' relationship to their employer dramatically changes. No longer will workers be as willing to complain about working conditions or

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213. Because the LSC regulations only permit representation of H-2A workers, LSC-funded programs would not have been authorized to represent the new H-2C workers of the Pombo bill. *See supra* note 192.

214. *See supra* Part III.B. This requirement, no doubt, is included to prevent the type of mass exodus from agriculture of the "legalized" work force that occurred after the 1986 SAW program. DANIEL ROTHENBERG, *WITH THESE HANDS: THE HIDDEN WORLD OF MIGRANT FARM WORKERS TODAY* 144 (1998).

215. *Agricultural Opportunities Act: Hearing on H.R. 4548 Before the Subcomm. on Immigration and Claims of the House Comm. on the Judiciary*, 106th Cong. 41 (2000) (statement of John R. Fraser, Deputy Administrator, Wage and Hour Division, U.S. Dep't of Educ.) (citing National Agricultural Worker Survey figures).

unjust employment practices, for fear of being prevented from obtaining the necessary number of work weeks under the legislation. The agricultural employer will have increased bargaining power in the work relationship, and inevitably some growers will use that power in an illegal manner to intimidate "uncooperative" workers.

3. *Compromise Legislation Concerns.*—The compromise legislation, in part, combined elements of both the Pombo proposal and the adjustment proposals. It would have lowered the number of days that a foreign agricultural worker needed to complete within six years to a total of 360.<sup>216</sup> Also, it would have altered the housing requirement and commissioned a study of the AEW.<sup>217</sup>

While the compromise would have pleased many growers and farm worker advocates, it is questionable whether it would really have resolved the long-term problems that exist within the migrant farm worker job market. History should be instructive on this point.<sup>218</sup> Under the many foreign agricultural worker programs that have existed, one thing has remained certain—there is always a need to find a new source of agricultural workers. Why exactly is there a constant need for government intervention to generate an agricultural workforce and not workers in other private sectors?<sup>219</sup>

4. *Gramm Proposal Concerns.*—Apparent from Senator Gramm's comments is his great concern about and desire to curb illegal immigration, while at the same time adjusting the current H-2A Program to be more useful to American growers. It is promising that Senator Gramm has had discussions with Mexican President Vicente Fox on the subject, and includes as one of his goals the fair treatment of all Mexican citizens working and living in the United States. However, given that Senator Gramm was opposed to the compromise legislation, it is difficult to predict what type of legislation he might propose that would satisfy his peers in the U.S. Senate. It is questionable whether his focus on substantially increasing employer sanctions for the use of undocumented workers would produce enough votes for passage of the legislation.

## V. SOLUTIONS TO POLICY CONCERNS

The underlying issue often ignored by Congress when it is debating new legislation on foreign agricultural workers is why U.S. growers constantly need to be supplied with a new work force. Why does the former work force choose alternative employment over agricultural work? Although farm work is difficult, it can be no more difficult than that of some factory workers; yet, the federal government is not called upon every few decades to readjust programs to allow for foreign factory workers. Why not? What sorts of obstacles hinder the continuation of a steady, migrant, agricultural work force?

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216. See *supra* Part III.C.

217. See *supra* Part III.C.

218. See *supra* Part I.

219. See *infra* Part V.



### A. "Agricultural Exceptionalism"

The economic situation of many family farms is not unknown to most Americans today. More and more family farms are losing ground to more industrial agricultural operations (not to mention land developers). Is this an American tragedy or just market forces exerting force over an outmoded form of business? Regardless of the answer, one thing is clear: as long as Americans continue to romanticize the situation of the American farmer, an expectation of governmental intervention will remain in the agricultural sector of the economy.<sup>220</sup> The farming business community believes that it is entitled to special treatment under the law. The disparate treatment of agribusiness from other sectors of the economy has come to be known as "agricultural exceptionalism."<sup>221</sup> This perception has taken many forms over the years, and its results will be scrutinized in this section of the Note.

Agricultural exceptionalism would not be so objectionable if other aspects of the agricultural economy were not harmed by it; however, the current plight of domestic migrant farm workers can be directly tied to its perpetuation. If this perception, and more importantly, its effects, are eliminated, the agricultural work force would stabilize enough so that there would no longer be a need for continued reliance on temporary, foreign agricultural worker programs.

#### 1. State-Based Exceptions.—

*a. Workers' compensation.*—Many states exclude migrant farm workers from compulsory eligibility under workers' compensation laws.<sup>222</sup> Such an outdated approach to migrant health care is atrocious, given that farm work is viewed as one of the most dangerous occupations in the United States.<sup>223</sup> Even though workers' compensation is generally governed by individual states, perhaps it is time to view the special difficulties associated with migrant labor injuries as a federal interstate commerce issue. Under such a theory, Congress

220. In 1962, Ernesto Galarza describes the relationship between the family farmer and agribusiness in the following way:

The identification of the small grower with the corporate industrial farm had long been a familiar device of image-making. In general its purpose was to drape the homespun look, the earthy simplicity, the hayseed frugality of the folk farmer over an industry that had none of these telluric charms. Agribusiness had grown into a vast, taut, complicated network of big production, big processing, big transportation, big financing and big marketing.

GALARZA, *supra* note 6, at 241.

221. See generally *id.* at 106; Jim Chen, *Of Agriculture's First Disobedience and its Fruit*, 48 VAND. L. REV. 1261 (1995); Guadalupe T. Luna, *An Infinite Distance?: Agricultural Exceptionalism and Agricultural Labor*, 1 U. PA. J. LAB. & EMP. L. 487 (1998).

222. See *supra* note 199 and accompanying text.

223. ROTHENBERG, *supra* note 214, at 7 (citing farm work as the occupation with "nation's highest incidence of workplace fatalities and disabling injuries"); see also RONALD L. GOLDFARB, *MIGRANT FARM WORKERS: A CASTE OF DESPAIR* 151 (1981) (citing farm work as one of the most dangerous occupations nearly twenty years ago).

would have the constitutional power to enact legislation to require agricultural employers to provide workers' compensation for their employees.<sup>224</sup>

*b. Unemployment insurance coverage.*—Another disgraceful aspect of many states' denial of economic rights to farm workers comes from migrants' effective exclusion from unemployment benefits.<sup>225</sup> While many policy reasons have been suggested for denying unemployment insurance coverage to agricultural workers (including the multi-state nature of the work), most of these problems have been resolved for other occupations.<sup>226</sup> In the end, this exception must be viewed as yet another entitlement provided to agri business by sometimes overly-sympathetic legislatures.

*c. State minimum wage laws.*—In addition to the federal minimum wage laws, many states have established their own minimum wages. Again, agricultural employees are often exempted from them.<sup>227</sup> Such laws rarely provide greater protections than those required by federal law, but there are occasions when state minimum wage laws apply to farm workers<sup>228</sup> and even require a higher wage rate than the federal minimum wage.<sup>229</sup> Such variations from the status quo of denying farm workers labor rights should be applauded.

## 2. Federal-Based Exceptions.—

*a. Fair Labor Standards Act.*—Under the Fair Labor Standards Act, migrant farm workers are completely exempted from some of the Act's protections, including overtime provisions, and partially from other protections, such as minimum wage and child labor provisions.<sup>230</sup> Thus, some farm workers do not have to even be paid federal minimum wages, while no farm worker needs to be paid overtime wages. Also, children as young as eleven years old are allowed to work in agriculture—already established as one of the most dangerous fields—so long as they work with their parents' permission.<sup>231</sup> Such leniency in the law

224. *Workmen's Compensation for Farmworkers, Hearings*, 92d Cong. 4 (1973) (statement of Robert E. McMillen, counsel for the United Farm Workers union) (likening Congress' ability to regulate farm laborers workers' compensation to Longshoremen's and Harbor Workers' Compensation Act, enacted in 1927).

225. See, e.g., IND. CODE § 22-4-8-2 (1)(1)(A) (1998) (requiring an agricultural employer "during any calendar quarter in either the current or preceding calendar year" to have paid remuneration of at least \$20,000 before the unemployment regulations apply to it); H.R. 1003, 107th Cong. (2001) (resolution to raise minimum amount growers must make in a quarter before they would be subject to unemployment tax from \$20,000 to \$50,000).

226. For a policy discussion on unemployment insurance coverage of farm workers, see SOSNICK, *supra* note 180, at 274-78.

227. See, e.g., IND. CODE § 22-2-2-3(m) (1998) (excluding "persons engaged in agricultural labor" from the definition of "employee," to whom Indiana minimum wage laws apply).

228. See, e.g., OR. REV. STAT. § 51-652.210 (1999) (farm workers are not excluded from definition of "employee").

229. See, e.g., *id.* § 51-653.025 (farm workers, as "employees," must be paid at least \$6.50 per hour under Oregon's minimum wage laws).

230. 29 U.S.C. § 213 (1994 & Supp. V 1999).

231. See *id.* §§ 212, 213(c).



exclusively for the benefit of agribusiness and at the expense of children is repulsive. No such exemptions exist for minors in other economic sectors, and neither should they exist in agriculture.

Perhaps when the Fair Labor Standards Act was enacted in 1938, the agricultural component of the U.S. economy necessitated special treatment; however, as the family farm has changed into a multi-billion dollar agribusiness, the need for special treatment has vanished.<sup>232</sup> There is evidence that the exclusion of farm workers from the original legislation may have been racially motivated.<sup>233</sup> Why would a farm laborer continue to work in an occupation in which minimum wages were not guaranteed and overtime work was uncompensated?

*b. National Labor Relations Act.*—One of the most harmful federal agricultural exceptions is that which excludes “agricultural laborer[s]” from the protection of the National Labor Relations Act (NLRA).<sup>234</sup> Because of their exclusion from the Act’s definition of “employee,” they are not protected from the retaliation that may occur as a result of their efforts to organize and collectively bargain.<sup>235</sup> Prior to the enactment of the NLRA, migrant farm workers actively organized themselves; however, after being excluded, such efforts diminished.<sup>236</sup>

Imagine the impact farm workers could have on their working conditions if they were able to organize and collectively bargain for wages.<sup>237</sup> Some have argued that there is such a right under international law.<sup>238</sup> Perhaps the results from such an organized system, although painfully new at first for growers, would reap benefits not only for the workers but for the industry as a whole.

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232. See ROTHENBERG, *supra* note 214, at 1.

233. For an expounding of this theory, see Marc Linder, *Farm Workers and the Fair Labor Standards Act: Racial Discrimination in the New Deal*, 65 TEX. L. REV. 1335 (1987).

234. 29 U.S.C. § 152 (1994).

235. *Id.* § 157; cf. SOSNICK, *supra* note 180, at 371-74 (explaining that one of the reasons Cesar Chavez embraced the agricultural exemption from the NLRA was so that farm workers would not be limited by the statute’s restrictions against secondary boycotts).

236. For an excellent review of pre-NLRA attempts to organize and the effects of the migrant exclusion from the NLRA, see Austin P. Morris, S.J., *Agricultural Labor and National Labor Legislation*, 54 CAL. L. REV. 1939 (1966); VARDEN FULLER, *LABOR RELATIONS IN AGRICULTURE* (1955).

237. Much has been written about the unionizing efforts of the United Farm Workers (UFW) and Cesar Chavez. See generally JOAN LONDON & HENRY ANDERSON, *SO SHALL YE REAP: THE STORY OF CESAR CHAVEZ & THE FARM WORKERS’ MOVEMENT* (1970); PETER MATTHIESSEN, *SAL SI PUEDES: CESAR CHAVEZ AND THE NEW AMERICAN REVOLUTION* (1969); RONALD B. TAYLOR, *CHAVEZ AND THE FARM WORKERS* (1975); JAN YOUNG, *THE MIGRANT WORKERS AND CESAR CHAVEZ* (1972). For a Midwest perspective on farmwork organizing, see W.K. BARGER & ERNESTO M. REZA, *THE FARM LABOR MOVEMENT IN THE MIDWEST* (1994).

238. LANCE A. COMPA, *UNFAIR ADVANTAGE: WORKERS’ FREEDOM OF ASSOCIATION IN THE UNITED STATES UNDER INTERNATIONAL HUMAN RIGHTS STANDARDS* (2000), <http://www.hrw.org/reports/2000/uslabor>.

Instead of growers expending such an incredible amount of money on lobbying efforts designed to guarantee a source of labor, they would be ensured a reliable work force. Moreover, growers could then turn their attention (and money) to more effectively managing their agricultural operations.

3. *Results of Agricultural Exceptionalism.*—What have been the results of this decades-old policy of agricultural exceptionalism? Has it been an incredible success story? As always, the answer depends on to whom the question is asked. For the agribusiness community that has profited tremendously thanks to its special treatment, its answer would likely be a most-resounding “yes.” However, for the farm workers losing out on the American dream as a result of this exceptionalism, the answer most definitely will be “no.”<sup>239</sup>

a. *Depressed wages.*—Farm workers are among the poorest laborers in the United States, averaging around \$6500 per year in income.<sup>240</sup> Farm workers have experienced “fewer weeks of employment; earned less per hour in real terms; [and] continued to have poverty level earnings.”<sup>241</sup> Given the low state of wages, it is suggested that instead of a labor shortage (as asserted by those desiring to increase use of H-2A workers) there is an over-supply of labor.<sup>242</sup> If there were a labor shortage, wages would not be falling but increasing so as to attract a sufficient number of employees. This fact illustrates one of the contradictions existing within the employment of farm workers: how can there be a “labor shortage” with lowering wages? The answer lies in the reliance of growers on undocumented workers.

b. *Increased reliance on undocumented workers.*—Growers want the best of all worlds. First, they reap the benefits of utilizing undocumented workers in the form of paying lower wages. At the same time, they petition Congress for a more reliable (and non-deportable) work supply through “guestworker” programs.<sup>243</sup> They are constantly seeking the cheapest source of labor without being concerned about how one practice creates the need for the other.

U.S. growers’ extreme reliance on undocumented workers has led to the

239. This harsh farm worker reality flies in the face of those who naively believe that if people only worked hard enough, they would be economically successful.

240. ROTHENBERG, *supra* note 214, at 6. This figure is based on the income of seasonal farm workers, while migratory farm workers only average about \$5000 per year. *Id.* The fruit and vegetable industry earns \$28 billion annually. *Id.* at 1-2.

241. *Agricultural Opportunities Act: Hearing on H.R. 4548 Before the Subcomm. on Immigration and Claims of the House Comm. on the Judiciary*, 106th Cong. 41 (2000) (statement of John R. Fraser, Deputy Administrator, Wage and Hour Division, U.S. Dep’t of Educ.) (citing National Agricultural Worker Survey figures).

242. Compare CHANGES, *supra* note 184, at 4 with STATUS, *supra* note 181, at 3-4 (agreeing that no farm labor shortage exists).

243. See, e.g., *Agricultural Opportunities Act: Hearing on H.R. 4548 Before the Subcomm. on Immigration and Claims of the House Comm. on the Judiciary*, 106th Cong. 112 (2000) (statement of Dewey Hukill for Texas Farm Bureau). The author has refrained from using the term “guestworker” throughout this Note because he feels that it misrepresents the nature of the relationship between the employer and laborer.



depression of wages for domestic workers, thus driving them out of agricultural work.<sup>244</sup> Why are growers using undocumented workers? Most agree that it is because foreign workers are less likely to complain about poor working conditions and unfair labor practices.<sup>245</sup> Some growers believed that the workers should be content with the privilege of working in the United States and receiving wages at all, even if they are lower than the law requires. Reports indicate that the use of undocumented agricultural workers has been steadily increasing.<sup>246</sup> As a result, few attempts are being made to retain the domestic work force and more reliance is being placed on undocumented workers.

c. *What Is the Solution?*—While there are no easy answers to addressing the problems of depressed wages and illegal immigration, any solution to stabilize the agricultural work force must factor in the role of the undocumented work force. Some approaches maintain that if the borders were more tightly secured and illegal immigration stopped, the working conditions of U.S. workers would improve.<sup>247</sup> Often included in such proposals, is an attempt to strengthen employer sanctions for using undocumented workers. However, illegal immigration to the United States seems to be inevitable as long as economic conditions in nearby countries continue to languish.<sup>248</sup>

Foreign “guestworker” programs are not the answer. As has been shown through the history of such programs, they are a temporary solution.<sup>249</sup> They merely provide a short-term answer while ignoring the long-term implications of inviting foreign workers into an area of the economy already deeply depressed. The situation of domestic agricultural workers has improved little since the introduction of foreign agricultural workers. A bolder step is necessary.

Perhaps international or trans-border unions should be used to incorporate the undocumented workforce into a solution, instead of labeling undocumented workers as the problem. At the same time, such a union would also assist

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244. ROTHENBERG, *supra* note 214, at 238 (recording comments of Jim Handelman, Farm Labor Specialist with the U.S. Department of Labor).

245. Philip Martin, *California's Farm Labor Market and Immigration Reform*, in *FOREIGN TEMPORARY WORKERS IN AMERICA* 193 (B. Lindsay Lowell ed., 1999).

246. Compare ROTHENBERG, *supra* note 214, at 127 (estimating the undocumented work force in agriculture to be one in four), with *Agricultural Opportunities Act: Hearing on H.R. 4548 Before the Subcomm. on Immigration and Claims of the House Comm. on the Judiciary*, 106th Cong. 41 (statement of John R. Fraser, Deputy Administrator, Wage and Hour Division, U.S. Dep't of Educ.) (estimating the same group to be about fifty percent of the agricultural work force).

247. See Gramm, *supra* note 169 (“I believe that an effective guest worker program can help the American economy . . . . The United States must seek to regain control of its border, to end the influx of illegal immigrants whose arrival is tacitly condoned and which produces contempt for the rule of law.”).

248. This paper does not address atrocities committed by the United States government in Latin America that have contributed to such conditions. For a brief overview of how U.S. policy affects the conditions in surrounding countries, see NOAM CHOMSKY, *TURNING THE TIDE: U.S. INTERVENTION IN CENTRAL AMERICA AND THE STRUGGLE FOR PEACE* (1985).

249. See *supra* Part I.

domestic workers in improving their working conditions. However, without including undocumented workers, such a unionizing effort is bound to fail. Strikebreakers, in the form of undocumented workers, would be too easy to locate. Trans-national agreements may also provide a possible solution. Although attempted in the past with Mexico rather unsuccessfully, now may be the time to renegotiate.

### *B. Additional Necessary Reforms*

1. *Increase Minimum Wage.*—The very least that Congress could do to ease some of the burdens of the domestic agricultural work force is to raise the minimum wage.<sup>250</sup> Given that migrant farm workers are among the poorest of the poor, a raise in the minimum wage would have dramatic effects upon their incomes.<sup>251</sup>

2. *Increase Resources for Enforcement of U.S. Labor Laws.*—Another way that Congress could assist the plight of migrant farm workers would be to increase funding for the enforcement of labor laws. The Wage and Hour Division of the U.S. Department of Labor is the agency primarily responsible for enforcing labor laws that affect migrant workers. It is extremely underfunded to accomplish its duty to properly monitor the migrant employment situation.<sup>252</sup>

In addition, Congress could fund more extensively another source for enforcing labor laws, namely, the Migrant Legal Services programs of the Legal Services Corporation. “Since few private attorneys are willing to take on farmworkers’ legal claims, virtually all labor-law cases alleging employers’ mistreatment of farmworkers have been brought by Legal Service attorneys.”<sup>253</sup> Increased funding, earmarked for the migrant legal service programs, would ensure the continued enforcement of laws protecting the employment rights of oppressed migrant farm workers.

### CONCLUSION

Many of the important themes discussed in this Note—illegal immigration, temporary foreign agricultural workers, and the economic conditions of domestic agricultural workers—have been debated in Congress for years. No easy solutions are obvious. However, one thing that can be unequivocally stated is that agricultural exceptionalism has existed for well over seventy years. Additionally, employment conditions of migrant farm workers have not improved over the same decades. There must be a direct connection between the two. If

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250. Am. Farm Bureau, *Minimum Wage* (Sept. 2001), <http://www.fb.org/issues/backgrd/minwage107.html> (stating that the American Farm Bureau Federation Policy “specifically opposes increases in the minimum wage . . .”).

251. Martin, *supra* note 245, at 185-86 (describing how a labor cost increase will have less effect on the cost of goods sold because farmers receive less from the sale of their products than other producers do).

252. ROTHENBERG, *supra* note 214, at 215.

253. *Id.* at 229.



agricultural exceptionalism in its current form continues to exist well into the twenty-first century, unfortunately the proposed solutions provided in this Note may still be debated seventy years from now.





# THE CASE AGAINST CARNIVORE: PREVENTING LAW ENFORCEMENT FROM DEVOURING PRIVACY

PETER J. YOUNG\*

## INTRODUCTION

The use of Carnivore, the Federal Bureau of Investigation's (FBI) electronic mail surveillance system,<sup>1</sup> and the more sophisticated surveillance technology that is certain subsequently to be developed,<sup>2</sup> obliterates the already precarious balance between the government's responsibility to provide for public safety through law enforcement and individuals' right to privacy. Carnivore's emergence sparked worldwide debate regarding the legal standards to be applied to the use of such technology. Shaping the debate are intense competing public interests, namely quashing rising rates of cybercrime<sup>3</sup> while upholding privacy rights, at a time when the popularity of conducting personal and business transactions via the Internet is skyrocketing.<sup>4</sup>

The FBI is using statutes originally enacted to govern telephone wiretapping, including Title III of the Omnibus Crime Control and Safe Streets Act of 1968<sup>5</sup>

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1. The Wall Street Journal broke the story of the FBI's use of its clandestine electronic surveillance system, bizarrely named "Carnivore," to monitor the electronic mail messages of suspected criminals. Neil King, Jr., *FBI's Wiretaps to Scan E-Mail Spark Concern*, WALL ST. J., July 11, 2000, at A3. The FBI chose the codename Carnivore because the diagnostic tool "chews all the data on the network, but it only actually eats the information authorized by a court order." Robert Graham, *Carnivore FAQ (Frequently Asked Questions)*, at <http://www.robertgraham.com/pubs/carnivore-faq.html> (Sept. 7, 2000). Adopting a less menacing name for its electronic surveillance system, the FBI began calling Carnivore "FS1000" in 2001. Maria Vogel-Short, *A Collision Course?: Public Safety vs. Civil Liberties*, N.J. LAW.: WKLY. NEWSPAPER, Nov. 5, 2001, at 1.

2. This more sophisticated surveillance technology is reported already to exist. Although its existence is unsubstantiated, "Echelon," the "largest technologically driven spy system ever known," is allegedly being operated by the United States, under the auspices of the National Security Agency, along with Great Britain, Canada, Australia, and New Zealand and accumulates more than three billion telephone, telegraph, radio, satellite, undersea cable, and Internet communications a day. Martin L. Haines, *The Secret Life of Echelon*, 160 N.J.L.J. 395, 395 (2000).

3. *Civil Liberties Groups Blast "Carnivore," Seek Privacy Protections*, ANDREWS EMP. LITIG. REP., Oct. 3, 2000, at 10 [hereinafter *Civil Liberties Groups Blast "Carnivore"*] (citing Kevin V. DeGregory, deputy attorney in the U.S. Justice Department, who reports that the FBI's Internet Fraud Complaint Center is receiving 1200 complaints each week).

4. In 1981, 300 computers had Internet access; in 1993, one million had access; and in January 2000, 72.4 million computers were connected to the Internet. Randall L. Sarosdy, *The Internet Revolution Continues: Responding to the Chaos*, METROPOLITAN CORP. COUNS., Sept. 2000, at 15.

5. See generally 18 U.S.C. §§ 2510-2522 (1968) (making wiretapping legal and currently

(Title III), the Foreign Intelligence Surveillance Act (FISA) of 1978,<sup>6</sup> the Electronic Communications Privacy Act (ECPA) of 1986,<sup>7</sup> and the Communications Assistance for Law Enforcement Act (CALEA) of 1994,<sup>8</sup> as justification for extending its authority under these laws to monitor electronic mail communications using Carnivore. These laws are patently inadequate when applied to the Internet medium. New comprehensive legal strategies that limit the government's authority to engage in electronic surveillance in an increasing number of ways without adequate oversight and accountability are imperative if public trust in law enforcement is to be preserved. Existing laws and court decisions on electronic surveillance seem to have been haphazardly initiated or adapted in lieu of enacting more comprehensive laws. These laws and decisions illuminate a confusing set of standards governing the various levels of protection given communications originating from diverse sources.<sup>9</sup>

Determining the circumstances under which Carnivore might be used is but one of many issues surrounding it; a much larger, central issue is whether this kind of electronic surveillance exceeds what the American people want the

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being used to govern the interception of electronic mail content).

6. See generally 50 U.S.C. §§ 1801-1863 (1994 & Supp. V 1999) (permitting federal agents to conduct electronic surveillance where probable cause exists to believe that targeting a foreign power or a foreign power's agent will result in evidence of a crime).

7. See generally Pub. L. No. 99-508, 100 Stat. 1848 (1986) (codified as amended in scattered sections of 18 U.S.C.) (extending Title III's privacy protections to cover electronic mail communications and requiring that content data from communications companies be released to the government only upon the government's meeting a probable cause standard; the act further provides that before the government can obtain records of telephone calls made or Internet addresses to which mail was sent, it must demonstrate the relevance of the records to a legitimate criminal investigation).

8. See generally Pub. L. No. 103-414, 108 Stat. 4279 (1994) (codified as amended in scattered sections of 18 and 47 U.S.C.) (giving the government authority to tap more sophisticated, digital telephone wiring and requiring telephone companies, but not ISPs, to modify their networks to accommodate wiretapping equipment).

9. For example, under current laws, the interception of an electronic mail message sent through a cable modem is more stringently protected than a telephone conversation, and significantly less demanding standards exist for capturing records of an individual's outgoing and incoming telephone and Internet communications. *Learning to Live with Big Brother*, J. REC. (Okla. City), Aug. 10, 2000, available at 2000 WL 14297544; see also 18 U.S.C. § 2515 (1994) (providing aggrieved persons a right to move for suppression of wire or oral, but not electronic communications). Whereas wire and oral communications are afforded the protection of a statutory exclusionary rule, electronic communications may only be able to be suppressed under the judicially crafted "fruit of the poisonous tree" doctrine. See, e.g., *United States v. Reyes*, 922 F. Supp. 818, 837 (S.D.N.Y. 1996) (observing that 18 U.S.C. § 2515 does not apply to electronic communications). Compare 18 U.S.C. § 2510(12) (1994) (defining electronic communication), with 18 U.S.C. § 2510(1) (1994) (defining wire communication), and 18 U.S.C. § 2510(2) (1994) (defining oral communication). But see, e.g., *United States v. Smith*, 978 F.2d 171, 175 (5th Cir. 1992) (applying 18 U.S.C. § 2515 to electronic communications).



capabilities of their government to be. To the FBI, the utility of Carnivore could not be more apparent—it has created a surveillance tool that undoubtedly increases its ability to effectively reach criminal suspects' communications. However, Carnivore's utility may come at too great a cost to the American people—sacrificing their right to privacy. One thing is clear—the Fourth Amendment,<sup>10</sup> now more than 200 years old, is showing signs of difficulty keeping up with the digital age.

Perhaps Carnivore will not prove to be the intolerable device that citizens regard as excessively offensive to their privacy rights. However, with the growing number of individuals worldwide becoming connected to the Internet every day, and the rapidly increasing technological competencies of law enforcement agencies to monitor the medium, one must constantly question how much invasion is too much.

This Note will introduce the Carnivore system and lay out the issues framing the debate around its use and potential for misuse. These issues necessitate an examination of the national and international explosion in Internet use, evidenced not only by the increased number of individuals connected to the Internet, but also in the kinds of functions in which these users are engaging. The private transactions that Internet users are conducting via the medium suggest that, contrary to some U.S. courts' characterization of Internet users as having a minimal expectation of privacy,<sup>11</sup> and thus expecting a lesser degree of protection from unreasonable searches and seizures, Internet users are expecting more privacy when sharing personal information with third parties online.

The Internet is a medium that transcends geographic boundaries. Therefore, although this Note will briefly detail the development of U.S. law as it relates to electronic surveillance, it will also consider the electronic surveillance practices and laws of other countries, focusing only on a few nations with recently enacted, far-reaching electronic surveillance laws.<sup>12</sup> Taking into account U.S. and international laws and policies, the Note will conclude with recommendations and proposals for transforming what has become an unbalanced policy, one substantially favoring law enforcements' interests, to one in which the integrity of worldwide Internet users' expectation of privacy is irrevocably secured.

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10. The Fourth Amendment provides that persons' right "to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, . . . but upon probable cause." U.S. CONST. amend. IV.

11. See, e.g., *Smyth v. Pillsbury Co.*, 914 F. Supp. 97, 101 (E.D. Pa. 1996); *McLaren v. Microsoft Corp.*, No. 05-97-00824-CV, 1999 WL 339015, at \*5 (Tex. App. May 28, 1999).

12. For a comprehensive discussion of worldwide privacy protections and surveillance laws, see generally David Banisar & Simon Davies, *Global Trends in Privacy Protection: An International Survey of Privacy, Data Protection, and Surveillance Laws and Developments*, 18 J. MARSHALL J. COMPUTER & INFO. L. 1 (1999).

## I. THE CARNIVORE ELECTRONIC MAIL SURVEILLANCE SYSTEM

### A. *Carnivore's Capabilities*

The discovery of the FBI's use of the Carnivore electronic mail surveillance system in July 2000<sup>13</sup> prompted numerous questions from privacy advocates and other interested citizens on the system's capabilities. The answers to those questions, provided by the few Justice Department officials who knew enough about the covert system to reply, exposed the tremendous ramifications that Carnivore can potentially have on privacy rights. The potential for abuse is palpable.

The Carnivore system, after being physically placed on Internet service providers' equipment, reads messages' address information and the subject lines describing their contents and can be programmed to capture this header information, servers and Web sites visited by a particular user, or messages' contents.<sup>14</sup> Despite its presence in their facilities and attachment to their computers, Internet service providers (ISPs) are not given access to the system, making the FBI exclusively knowledgeable of Carnivore's capabilities.<sup>15</sup> Only after the Electronic Privacy Information Center (EPIC) filed a Freedom of Information Act (FOIA) request seeking the FBI's records on the Carnivore system did the Justice Department agree to release the system's technical specifications to a group of non-FBI consultants, although it declined to suspend Carnivore's use until a thorough study could be conducted.<sup>16</sup> In October 2000, as a result of EPIC's FOIA request, the Justice Department released 729 pages of text documenting Carnivore's development, but of those 729 pages, 200 were completely withheld and another 400 were partially redacted.<sup>17</sup> The Justice Department's suppression of the information sought by EPIC led to further criticism of the FBI's seemingly unrestrained use of Carnivore.<sup>18</sup>

The FBI maintains that Carnivore can be programmed to garner only the specific kind of information authorized for seizure by a court order.<sup>19</sup> CALEA requires that before law enforcement officials engage in electronic mail searches, they secure a court order, certifying their belief that records of a suspect's electronic mail activity and other transactional data will be relevant to a

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13. King, *supra* note 1.

14. D. Ian Hopper, *FBI Has E-Mail Sniffer but Is It a Temptation for Agency to Snoop Too Far?*, CONN. L. TRIB., Aug. 7, 2000, at 16.

15. *Id.*

16. Stefania R. Geraci, *Electronic Privacy Information Center Confronts FBI over Internet Surveillance System*, E-COMMERCE, Aug. 2000, at 10.

17. *EPIC Gets First Set of FBI's "Carnivore" Documents*, ONLINE NEWSL. ITEM00298004, Nov. 1, 2000, available at 2000 WL 7550696.

18. *Id.*

19. *Digital Privacy and the FBI's Carnivore Internet Surveillance Program: Hearing of the S. Judiciary Comm.*, 106th Cong. (2000) [hereinafter *Digital Privacy*] (statement of Sen. Patrick Leahy).



legitimate criminal investigation.<sup>20</sup> However, the ability to narrowly tailor search inquiries does not substantially diminish concerns that Carnivore will be used to capture more than that which it is authorized to catch. U.S. Senator Patrick Leahy, while acknowledging that judges may be offended by his impression, has suggested that a court order is often “designed exactly the way the government wants it to be.”<sup>21</sup> Moreover, the protection a court order possibly provides notwithstanding, no procedural safeguard can ever exist that would prevent a rogue FBI agent from manipulating Carnivore to capture unlawfully electronic communications. Once these communications have been intercepted, this information may well end up in the FBI’s files, whether or not it emanated from or was sent to the subject of a criminal investigation.

### *B. How Carnivore Works*

Understanding how Carnivore works requires a basic knowledge of how the Internet functions. Once a user has an ISP, which draws on high-powered computers and high-speed, high-volume communications channels to connect to other ISPs, the user can connect to the Internet.<sup>22</sup> Once a user is connected to the Internet, or “online,” the user can be assigned a unique electronic mail address, usually consisting of the user’s name or alias followed by the symbol “@” and the ISP’s name, allowing the user to correspond over the Internet via electronic mail with other users.<sup>23</sup>

The information contained in electronic mail messages flows through the Internet in “packets.”<sup>24</sup> A sender’s message is broken down into multiple packets as it traverses the Internet, with each packet containing header information, identifying the sender’s electronic mail address, intended recipient’s electronic mail address, and subject of the message.<sup>25</sup> As the packets come through the ISPs’ systems, Carnivore reads the header information, and if it is to or from a targeted electronic mail address or person, Carnivore will record the address information or the entire packet, according to the court order, on its hard disk.<sup>26</sup> Later, an FBI agent can read the recorded information.

By September 2000, the Carnivore system had been used twenty-five to thirty times.<sup>27</sup> The precise outcomes of these electronic surveillances, specifically regarding what information was harvested as a result of the searches, was not released because the FBI indicated that most of the cases in which Carnivore was

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20. 47 U.S.C. § 1002(a)(2) (1994).

21. *Digital Privacy*, *supra* note 19.

22. *Communications-Technology: Decoding the Internet: An Online Primer*, INTER PRESS SERV., Apr. 23, 1996, available at 1996 WL 9810171.

23. *Id.*

24. James H. Johnston, *Beware of Carnivore’s Voracious Appetite*, LEGAL TIMES, Sept. 4, 2000, at 29.

25. *Id.*

26. *Id.*

27. *Digital Privacy*, *supra* note 19 (statement by Donald M. Kerr, Assistant Director, FBI).

used involved issues of national security.<sup>28</sup> However, the FBI's unwillingness to release the results of Carnivore's quests, even in indistinct terms, engenders less public confidence that Carnivore is intercepting only that which it is authorized to intercept by a court order.

*C. Competing Interests: Privacy v. Law Enforcement*

1. *Privacy*.—U.S. citizens immediately expressed concern about Carnivore after learning of its existence. Although the right to privacy is not mentioned in the U.S. Constitution, it is a right that U.S. citizens consider fundamental.<sup>29</sup> The Fourth Amendment of the United States Constitution is the primary constitutional provision from which an inferred right to privacy can be drawn, but even it does not explicitly refer to privacy.<sup>30</sup> Nevertheless, a right to privacy is embodied in what U.S. Supreme Court Justice Brandeis called the most inalienable of rights—"the right to be let alone."<sup>31</sup> In protecting that right, Brandeis believed that "every unjustifiable intrusion by the Government upon the privacy of the individual, whatever the means employed, must be deemed a violation of the Fourth Amendment."<sup>32</sup>

Carnivore's ability to scan millions of electronic mail messages per second, making the government capable of eavesdropping on all Internet users' communications,<sup>33</sup> instinctively offends a sense of the right to privacy. Yet, objections to Carnivore go beyond the assertion that the system contravenes personal rights. More elemental claims are that the FBI lacks the authority to use Carnivore, that the secrecy surrounding the diagnostic tool makes it more likely that it will be abused, and that Carnivore's use detrimentally affects users' trust in the Internet medium itself and in blameless ISPs.

a. *Misusing statutes*.—Privacy advocates contend that statutes intended to govern rudimentary electronic surveillance, including those that amended earlier statutes to cover Internet surveillance, are being excessively stretched in that certain types of searches occurring via the Internet are unacceptable extensions of telephone wiretapping laws.<sup>34</sup> Even the most primitive electronic mail searches can yield substantive information about the subject matter contained in the body of a message and personal information about an Internet user. These

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28. D. Ian Hopper, *Papers Contradict FBI on Carnivore*, AP ONLINE, Nov. 18, 2000, available at 2000 WL 29579830.

29. ELLEN ALDERMAN & CAROLINE KENNEDY, *THE RIGHT TO PRIVACY* xiii (1997).

30. See U.S. CONST. amend. IV; see also ALDERMAN & KENNEDY, *supra* note 29, at xvi (suggesting sources other than the federal Constitution in which courts have explicitly found or inferred rights to privacy: state constitutions, federal and state statutes, and judicial decisions).

31. *Olmstead v. United States*, 277 U.S. 438, 478 (1928) (Brandeis, J., dissenting).

32. *Id.*

33. Geraci, *supra* note 16, at 10 (taking language from a Memorandum in Support of Plaintiff's Motion for a Temporary Restraining Order, *EPIC v. Dep't of Justice*, No. 00-1849 JR. (D.D.C. Aug. 2, 2000) No. 00-1849 JR.).

34. Hopper, *supra* note 14.



basic electronic mail searches are far more intrusive than comparable telephone record searches, which yield only the numbers to which calls were made and from which calls were received. Yet, the standards governing law enforcement's access to the telephone and Internet records are the same.

The addresses to and from which messages are sent and received, and Web sites visited by a particular Internet user, can potentially expose considerable information about an individual. Hundreds of electronic mail messages can be sent simultaneously to other users, suggesting to someone reviewing a list of those to whom the messages were sent some connection among recipients. Similarly, reviewing a list of Web sites an individual has visited might reveal voluminous amounts of information about the person. Telephone wiretapping laws modified to apply to Internet use simply do not provide adequate privacy protections when applied to the Internet medium.<sup>35</sup>

*b. Shrouded in mystery.*—Another primary concern about the use of Carnivore arises from the mystery that surrounds it. Not only does the public know very little about Carnivore, but even ISPs, which are required to allow Carnivore to be attached to their equipment, are not provided access to the system.<sup>36</sup> Only the FBI knows how the system operates. Contrary to the procedure it follows when seeking to obtain telephone records from telecommunications companies under current law, the FBI retains full control of Carnivore, rather than allowing ISPs to provide the information in compliance with court orders.<sup>37</sup> This mystery prevents ISPs and their customers from knowing exactly what Carnivore does, what it reads, and its capabilities and limitations.

*c. Potential for abuse.*—Closely related to the problem of Carnivore's mysteriousness is the concern that it could be used for purposes other than those for which it is supposedly intended. Given Carnivore's ability to scan every electronic mail message that comes through an ISP's network, it is easy to

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35. *Id.*

36. *Devouring Privacy*, CONN. L. TRIB., Aug. 21, 2000, at 22. *But see* Jason Fry, *Tech Week in Review: Web-Privacy Advocates Battle Plan*, DOW JONES NEWS SERV., July 17, 2000 (indicating that ISP EarthLink, objecting to having Carnivore installed on its equipment on various grounds, including its inability to know that for which Carnivore is seeking and what it intercepts, the legal jeopardy from its customers in which it puts itself, and the incompatibility of Carnivore with its advanced operating system, unsuccessfully challenged the FBI in court). Later, however, EarthLink struck a deal with the FBI to provide any data the FBI needs without the FBI having to install Carnivore on its network. *Id.*

37. *Id.*; *see also* Margaret Coker, *In Russia, Privacy Will Come to an End if 'You've Got Mail'*; *New Law Will Allow Government to Monitor Internet, Cell Phones, and Pagers*, AUSTIN AM.-STATESMAN, Sept. 10, 2000, at A17 (quoting a Russian telecommunications company executive's statements about Russia's Carnivore-like electronic surveillance system, S.O.R.M.: "We cannot see what they are doing, when they are tapping in. We can only trust that they are not working against our clients' interests."); *Learning to Live with Big Brother*, *supra* note 9 (suggesting that rather than giving the FBI unlimited access to networks, less intrusive alternatives exist, including ordering ISPs to turn over the specific material demanded by a court order).

conceive that the system could be used to monitor unpopular groups or political enemies.<sup>38</sup> Critics have suggested that Carnivore might be used to search electronic mail users' messages for phrases like "overthrow the government," in turn leading to the sender to becoming the subject of increased surveillance.<sup>39</sup>

*d. Chilling effect.*—Given its perceived potential for abuse, the very knowledge that the FBI has the ominous capabilities provided by Carnivore can have a detrimental effect on Internet users' confidence in the integrity of the medium. The use of Carnivore may increase the uncertainty of innocent citizens who are already concerned about Internet privacy.<sup>40</sup> Users should not have to limit their behavior out of fear that their government may be eavesdropping on them when using a medium that should be considered private.<sup>41</sup>

*e. Putting ISPs in a compromising position.*—Carnivore's current use forces ISPs to become unwilling parties to criminal investigations.<sup>42</sup> Ultimately, putting ISPs in this accessory role will undermine consumer trust. Compounding this already undesirable situation is that the telecommunications industry is caught between not wanting to spend the money to build in the Carnivore equipment (assuming it would then have control over the system) and being equally concerned about cybercrime, another important consumer-confidence issue.<sup>43</sup>

*2. Law Enforcement.*—Despite their extensive list of privacy concerns, even the most zealous privacy advocates recognize the importance of maintaining some of the government's electronic surveillance capabilities. To be able to meet their obligation to provide for public safety, law enforcement agencies need the appropriate tools in which to engage in sophisticated crime-fighting techniques. Accordingly, compelling arguments can be made for allowing the FBI to conduct some degree of electronic mail surveillance. These arguments include the prospect of reversing the rising rates of cybercrime, the potentiality of high-tech diagnostic tools to conduct searches that are minimally intrusive, and the general societal interest in technological advancement.

*a. Increased criminal activity.*—Electronic mail communication is increasingly used among criminals, indicative of law enforcement's need to have some manner by which to access these communications.<sup>44</sup> In fact, the FBI's rationale for developing the Carnivore technology centers around its observation that the nation's electronic communications networks are routinely being used by criminals in committing serious crimes, including terrorism, espionage,

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38. *Learning to Live with Big Brother*, *supra* note 9.

39. Johnston, *supra* note 24.

40. *Digital Privacy*, *supra* note 19 (statement of Jeffrey Rosen, Professor, George Washington University Law School).

41. *Id.*

42. Elisabeth Frater, *Law Enforcement: The Carnivore Question*, NAT'L J., Sept. 2, 2000 (referring to a comment by Jeff Richards, executive director of Internet Alliance).

43. *Id.* (referring to statement by Stuart Baker, former counsel to the National Security Agency).

44. *Learning to Live with Big Brother*, *supra* note 9.



organized crime, and drug trafficking.<sup>45</sup> Some law enforcement officials have even characterized the surveillance of electronic communications as privacy enhancing.<sup>46</sup> At any rate, there can be little doubt that routine surveillance would likely curb the escalating cybercrime statistics.

*b. Narrowly-tailored use.*—Proponents of Carnivore suggest that use of the system could actually be a less-intrusive means of electronic surveillance than that currently authorized under federal law.<sup>47</sup> The FBI notes that unlike telephone taps that pick up all activity on a particular telephone line, the Carnivore system has the potential to be programmed to “pick up the e-mail from only one sender and a particular computer.”<sup>48</sup> In addition to the purported ability of the system to be programmed to receive only the information authorized by a court order, the FBI argues that it is difficult to obtain an internal order to use Carnivore; an application must be signed by a high-level Justice Department official and must indicate why other investigative measures will not work.<sup>49</sup>

*c. Encouraging technological innovation.*—The last century has witnessed a technological revolution. As an example, telephones, once obtainable by only a select few, have become household items. Over the last decade, the explosive growth in the number of individuals owning computers suggests that it too will become as indispensable a household staple as the telephone.<sup>50</sup> Moreover, the telephone and computer represent only a fraction of the products that have resulted from this technology boom. Although whether the social impact of such devices has been favorable can be debated, our society is one that highly values technological progress. Arguably, the FBI’s development of Carnivore represents a significant advance in electronic surveillance capabilities. With this kind of technological innovation being encouraged, the development of more sophisticated surveillance technology is a valid goal of law enforcement agencies.

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45. Fed. Bureau of Investigation, *FBI Programs and Initiatives—Carnivore Diagnostic Tool*, available at <http://www.fbi.gov/programs/carnivore/carnivore2.htm> (last visited Jan. 15, 2001) (arguing that evidence garnered through electronic surveillance is superior to many forms because it offers juries opportunities to determine the facts of a case based on criminal defendants’ own words).

46. Frater, *supra* note 42 (quoting David Green, the Justice Department’s principal attorney for computer crimes: “When we’re investigating the hacker who’s stolen your ID, then [Carnivore is] privacy-enhancing.”).

47. *See generally* 47 U.S.C. §§ 1001-1010 (1994).

48. *Learning to Live with Big Brother*, *supra* note 9.

49. Geraci, *supra* note 16, at 10; Fed. Bureau of Investigation, *supra* note 45 (offering that court orders are limited to a specified time, and judges may and often do require periodic progress reports, thus ensuring close oversight).

50. EVAN HENDRICKS ET AL., *YOUR RIGHT TO PRIVACY: A BASIC GUIDE TO LEGAL RIGHTS IN AN INFORMATION SOCIETY* 68 (2d ed. 1990).

## II. INCREASED GLOBAL INTERNET USE AND DOMESTIC AND INTERNATIONAL LEGAL RESPONSES TO ELECTRONIC SURVEILLANCE AND PRIVACY PROTECTIONS

The digital age is having profound impact on the ways in which people engage in day-to-day activities. Not long after the number of personal computers in offices and homes exponentially grew, Internet connections followed the same trend. During the past twenty years, the number of computers with Internet access increased from 300 in 1981 to 72.4 million in 2000.<sup>51</sup> The Internet has become a dominant means for individuals to conduct business, get news and information, engage in personal and professional communications, and entertain themselves.<sup>52</sup> People no longer are simply using their computers as data processors or to play games. Rather, household appliances are now being wired to the Internet and many "personal thoughts and associations" are transmitted via computer.<sup>53</sup>

This sizable increase in the level of Internet use in the United States warrants closer attention directed to electronic mail surveillance. However, the medium is a unique one in that "[n]ational boundaries have little meaning on the Internet."<sup>54</sup> The Internet allows individuals on any networked computer anywhere in the world to exchange instantaneously information with one another. Electronic mail can be sent from an individual in one country to an individual in another in a matter of seconds. These extraordinary properties of the Internet necessitate both domestic and international responses.

### A. Domestic Responses

The U.S. Congress' good intentions are evident in the ways in which it is attempting to balance law enforcement needs with privacy protections when it comes to Internet surveillance. One way in which Congress is dealing with the issue of online privacy is through impending legislation. In Fall 2000, at least fifteen bills were pending in Congress that dealt with online privacy.<sup>55</sup> Given the monumental amount of recent attention being given to privacy as it relates to Internet use, these laws are presumably, at least in part, being proposed to bolster Internet users' privacy protections. Yet, despite Congress' good intentions, development in this dynamic area of the law is extremely slow, partially due to the constantly changing nature of electronic advances. However, in support of new laws being deliberated, Capital Hill hearings on the subject of Carnivore and digital privacy are being held,<sup>56</sup> indicative of the legislature taking steps toward

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51. Sarosdy, *supra* note 4, at 15.

52. *Digital Privacy*, *supra* note 19 (statement of Sen. Orrin Hatch) (citing a report stating that over 40 million Americans are currently using the Internet and there are 55,000 new users every day).

53. *Learning to Live with Big Brother*, *supra* note 9.

54. *Communications-Technology*, *supra* note 22.

55. Sarosdy, *supra* note 4, at 15.

56. See, e.g., *Digital Privacy*, *supra* note 19.



securing greater privacy protections.

### *B. International Responses*

1. *The United Kingdom's Regulation of Investigatory Powers Act.*—The Regulation of Investigatory Powers Act (“R.I.P.”), adopted in the United Kingdom in 2000, is a comprehensive piece of legislation that explicitly provides for the interception and acquisition of electronic communications by U.K. security agencies.<sup>57</sup> R.I.P. requires ISPs operating in the United Kingdom to attach Carnivore-like systems to their equipment for use in assisting law enforcement officials with monitoring suspected criminals’ electronic communications.<sup>58</sup> Unlike its statutory counterparts in the United States, R.I.P. does not mandate that a search warrant be granted by a judge to allow e-mail surveillance; rather, a “home secretary,” an elected politician, can issue warrants.<sup>59</sup> The Act also requires ISPs to turn over decryption keys or convert messages into plain text following approval from certain officials, including senior police officers.<sup>60</sup>

Carnivore and R.I.P. share similarities beyond their equally threatening names. British businesses, trade unions, newspapers, and civil liberties groups have voiced significant opposition to R.I.P.<sup>61</sup> Some business owners have even threatened to leave Great Britain rather than accept the cost and intrusion of the R.I.P. Act’s mandates.<sup>62</sup> R.I.P. opponents also argue that the bill breaches fundamental rights—namely privacy, liberty, expression, and association—all slated soon to be incorporated into British law according to the European Convention on Human Rights.<sup>63</sup> In December 2000, British politicians declined to support requests from U.K. security agencies to grant them additional powers under R.I.P. prior to Britain’s impending general election.<sup>64</sup>

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57. See generally Regulation of Investigatory Powers Act, 2000, c. 23 (Eng.).

58. See *7 Days—No Escape from the Spooks*, COMPUTING, Aug. 24, 2000, at 16 (suggesting that if governments want to intercept electronic communications they will do it with or without legal authority, and will only go through the legal process if the information is necessary for a court proceeding).

59. Steven Semeraro, *If Only R.I.P. Bill Really Could R.I.P.*, NAT’L L.J., Aug. 14, 2000, at A18.

60. *Id.*

61. *Id.*

62. *Id.*; see also Laura Rohde, *U.K. E-Mail Law Reaches U.S. Although Most American Companies Don’t Know It Yet, the U.K.’s R.I.P. Act Has Far-Reaching Ramifications for Those Doing Business There*, INFOWORLD, Sept. 4, 2000, at 2000 WL 20918065 (speculating that U.S. companies worried about security breaches due to the British R.I.P. may choose not to establish business operations in the United Kingdom).

63. Semeraro, *supra* note 59.

64. Jimmy Burns & Jean Eaglesham, *Ministers Shun Call for New Snooping Powers*, FIN. TIMES (Eng.), Dec. 5, 2000, at 4.

2. *Russia's System of Operational and Investigative Measures.*—In September 2000, Russia's System of Operational and Investigative Measures (known by its Russian acronym S.O.R.M.) law was amplified, giving the Russian Intelligence Agency (formerly the K.G.B.) the legal authority to conduct relatively unbridled electronic surveillance of its citizens' (and consequently non-citizens') Internet traffic, as well as cellular telephone and pager communications, with an easily-attainable warrant, but without the user's knowledge.<sup>65</sup> Like the United Kingdom's implementation of R.I.P., Russian regulations will require ISPs to equip networks with surveillance devices designed to transmit information to security service headquarters.<sup>66</sup> Yet, the reach of S.O.R.M. is even more disturbing—it requires all Internet communications to pass through clearinghouse sites and prohibits encryption attempts.

Opposition to Russia's law parallels the opposition movement by U.S. and British objectors to Carnivore and R.I.P. Russian protesters argue that no system of checks and balances exists to prevent its federal security agency from using information for "political blackmail," commercial espionage, or any other reason.<sup>67</sup> The right to privacy seems especially important in Russia, a fledgling democracy, where the Internet has provided a medium for the country's citizens to criticize their government, a fundamental democratic right.<sup>68</sup>

3. *Additional Responses.*—In addition to the United States, Britain, and Russia, other countries have recently adopted or are considering adopting electronic surveillance laws.<sup>69</sup> Singapore and Malaysia have enacted laws similar to those enacted in Great Britain and Russia, allowing for electronic mail surveillance with minimal privacy protections in place.<sup>70</sup> Japan has also enacted electronic mail-tapping legislation.<sup>71</sup> Japanese legislation requires ISPs to keep a pen-register-type record of all Internet communications traveling through their networks.<sup>72</sup> These records must be made available to law enforcement officials when a subpoena is issued.<sup>73</sup> Conversely, in the Netherlands, a robust public debate is occurring over whether the government should have authority to access

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65. Coker, *supra* note 37.

66. *Id.* But see Guy Chazan, *Russia Backs Down on Tapping E-Mail Traffic Without a Warrant: 'You Can Challenge Authorities and Not Only Survive But Win,'* WALL ST. J. EUR., Nov. 27, 2000, at 23 (stating that when a Russian provincial ISP challenged S.O.R.M. by filing a complaint in a Russian court after refusing to install the surveillance system on his equipment, basing his claim on a confidentiality agreement signed with his customers and a provision in his business license making disclosure of his clients' personal data a criminal offense, the government backed down, with ministers declaring that Russia needed further legislation).

67. Coker, *supra* note 37.

68. *Id.*

69. Semeraro, *supra* note 59.

70. *Id.*

71. *7 Days—No Escape from the Spooks*, *supra* note 58.

72. Graham, *supra* note 1.

73. *Id.*



electronic mail messages at all.<sup>74</sup>

### *C. International Law Enforcement Telecommunications Seminar*

Recent developments in electronic surveillance activities around the world are no coincidence. The FBI has taken the lead in convening an international coordinating group responsible for harmonizing nations' schemes to make it easier to intercept information from telecommunications systems around the globe.<sup>75</sup> The group, called the International Law Enforcement Telecommunications Seminar (ILETS), has secretly met annually for the past seven years.<sup>76</sup> The Seminar's plans to compel ISPs all over the world to install Carnivore-like "black boxes" on their servers surfaced in 1999, unveiling the FBI's intent that countries all over the globe work in concert to conduct the kind of electronic mail surveillance that Carnivore and its successors make possible.<sup>77</sup>

As the ILETs devised its cooperative worldwide electronic surveillance strategy, it excluded from its discussions lawyers and industry experts who could have provided advice on protecting privacy.<sup>78</sup> In fact, the formation of the global communications' interception alliance was "without parliamentary or public discussion or awareness" all together.<sup>79</sup>

## III. BALANCING PRIVACY PROTECTIONS WITH LAW ENFORCEMENT'S ELECTRONIC SURVEILLANCE NEEDS

### *A. U.S. Case Law: The Fourth Amendment*

In its first consideration of whether warrantless wiretapping of a criminal suspect's telephone violated the Fourth Amendment, the Supreme Court determined that where surveillance did not include physical intrusion on the defendant's property and no material objects were seized, no constitutional violation existed.<sup>80</sup> Nearly forty years later, the Court reversed its position on

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74. *Learning to Live with Big Brother*, *supra* note 9.

75. Duncan Campbell, *Many Governments Tapping E-Mails*, CANBERRA TIMES (Austl.), Aug. 21, 2000, at 16.

76. *Id.*

77. *Id.*

78. Duncan Campbell, *The Spy in Your Server: There Is No Hiding Place on the Net as Governments Around the World Chase Your Data*, GUARDIAN (U.K.), Aug. 10, 2000, at 2000 WL 25045488 (suggesting that as a result of the exclusion of these individuals, laws based on the ILETs's arrangements have led to worldwide controversies).

79. *Connected: How the NSA Has Spread Its Web over the Globe*, DAILY TELEGRAPH (Eng.), Feb. 17, 2000, at 2000 WL 12384227.

80. *Olmstead v. United States*, 277 U.S. 438, 466-67 (1928). *But see id.* at 474 (Brandeis, J., dissenting) (predicting that "[w]ays may some day be developed by which the Government, without removing papers from secret drawers, can reproduce them in court . . .," invading individual security).

wiretapping, holding in two cases decided within a few months of one another that the Fourth Amendment protects people and not places.<sup>81</sup> In one of the two cases, *Katz v. United States*, the government's electronic surveillance, listening to and recording a criminal suspect's words while he was having a phone conversation in a telephone booth, was deemed to have invaded the privacy upon which the defendant had relied.<sup>82</sup> The Court determined that the law enforcement officers' actions constituted an unreasonable search and seizure without a warrant under the Fourth Amendment.<sup>83</sup> The Court found it insignificant that the surveillance device used by the government did not penetrate the walls of the booth. The *Katz* analysis shifted the focus from the means of communication to the communication itself as the source of a constitutional right.<sup>84</sup> Following *Katz*, which remains sound precedent for limits on Fourth Amendment wiretapping, the Court held in subsequent cases that application of the Fourth Amendment depends on whether a claimant can invoke a "legitimate" or "reasonable" expectation of privacy.<sup>85</sup>

In 1979, in *Smith v. Maryland*,<sup>86</sup> the Court considered whether police violated a criminal suspect's Fourth Amendment rights when the police installed a pen register on the suspect's telephone line without a warrant to record the numbers dialed from the phone. Using the standard established in earlier cases in which telephone wiretapping was deemed to be a search under the Fourth Amendment,<sup>87</sup> the Court required the claimant to establish that he held a subjective expectation that the numbers dialed were a matter of privacy and that this expectation was one society recognizes as reasonable.<sup>88</sup> Because the pen register was installed on the phone company's property, the petitioner could not claim invasion of a constitutionally protected area, and instead rested his claim on an expectation of privacy.<sup>89</sup> The Court rejected the privacy argument, determining that because pen registers do not acquire the contents of communications, but only the numbers dialed, and all numbers dialed go through phone companies that customers know make records, no expectation of privacy can reasonably exist.<sup>90</sup> Therefore, the Court determined that information gathered by the pen registers are not Fourth Amendment "searches" and hence do not require warrants.<sup>91</sup>

Today, law enforcement requests for pen-register and trap-and-trace records

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81. *Katz v. United States*, 389 U.S. 347, 351 (1967); *Berger v. New York*, 388 U.S. 41, 51 (1967).

82. *Katz*, 389 U.S. at 353.

83. *Id.*

84. See *Digital Privacy*, note 19 (statement of Michael O'Neill, Professor, George Mason University Law School).

85. See, e.g., *Rakas v. Illinois*, 439 U.S. 128, 143 (1978); *Terry v. Ohio*, 392 U.S. 1, 9 (1968).

86. 442 U.S. 735 (1979).

87. See *Katz*, 389 U.S. at 352-53; *Berger v. New York*, 388 U.S. 41, 51 (1967).

88. See *Katz*, 389 U.S. at 361 (Harlan, J., concurring).

89. *Smith*, 442 U.S. at 741.

90. *Id.*

91. *Id.* at 745-46.



are granted “without question” by federal courts.<sup>92</sup> Pen-register and trap-and-trace records in the electronic communications context are records of “to-and-from e-mail addresses” and Web site visit histories.<sup>93</sup>

### *B. U.S. Statutory Law*

Immediately after the Supreme Court issued the opinion in which it identified the requisite showing a claimant must make to prove an unreasonable search under the Fourth Amendment, Congress passed Title III.<sup>94</sup> Title III requires the government to obtain a court order before tapping wire communications or eavesdropping on an oral conversation in which parties have an expectation of privacy.<sup>95</sup> In order to obtain a warrant, the government has to demonstrate probable cause, define the surveillance parameters, and explain why other investigative techniques will not work.<sup>96</sup> Although the Act requires that minimal notice be given to parties targeted by wiretapping, the provision is considered by many to be too vague, and no notice is required to be given to non-targets who are part of the conversations.<sup>97</sup>

Recognizing that Title III applied only to the expectation of privacy in conversations that could be heard, Congress sought to modify the law covering computer technology where the question of whether an expectation of privacy exists is blurred.<sup>98</sup> The Electronic Communications Privacy Act (ECPA) was the first federal statute to specifically address the surveillance of electronic communications.<sup>99</sup> The ECPA extended protections afforded aural communications to non-aural communications, thereby safeguarding unwarranted interceptions of the content of electronic mail.<sup>100</sup>

In 1994, Congress passed the Communications Assistance for Law Enforcement Act (CALEA).<sup>101</sup> CALEA makes it possible for the government to tap more modern digital telephone wiring and requires telephone companies to modify their equipment to accommodate wiretapping devices.<sup>102</sup> As it pertains to electronic mail, CALEA requires a court order, but not probable cause, for the government to obtain electronic mail addresses and other transactional data.<sup>103</sup>

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92. *Learning to Live with Big Brother*, *supra* note 9.

93. *Civil Liberties Groups Blast “Carnivore,”* *supra* note 3.

94. *See generally* 18 U.S.C. §§ 2510-2522 (1994) (incorporating basis for Title III).

95. *Id.*

96. HENDRICKS ET AL., *supra* note 50, at 69.

97. *Id.*

98. *Id.* at 70-71.

99. *See generally* Pub. L. No. 99-508, 100 Stat. 1848 (1986) (codified as amended in scattered sections of 18 U.S.C.).

100. HENDRICKS ET AL., *supra* note 50, at 71.

101. *See generally* Pub. L. No. 103-414, 108 Stat. 4279 (1994) (codified as amended in scattered sections of 18 and 47 U.S.C.).

102. *Id.*

103. *See* 47 U.S.C. § 1002(a) (1994).

However, CALEA does not require ISPs to modify their equipment to accommodate interception.<sup>104</sup>

Privacy advocates contend that in the FBI's battle to get CALEA passed, it explicitly stated that it did not want more surveillance capacity than it already had, but rather simply wanted to conduct surveillance in new ways made possible by new technologies.<sup>105</sup> Yet, ultimately, the FBI's authority under CALEA seemed to include dictating wiretapping technical standards while telecommunications systems were still in an explosive period of development.<sup>106</sup>

### C. *Expectation of Privacy*

Some World Wide Web users would be surprised to learn that site administrators can detect their e-mail address, sites they have previously visited, and other information to be used for marketing purposes.<sup>107</sup> Electronic mail users may also be surprised to find out that copies of their messages may remain on ISPs' servers long after recipients have deleted them.<sup>108</sup>

As a result of third parties' ability to access electronic mail messages sent and Web sites addresses visited, courts have determined that electronic communicators have a reduced expectation of privacy in their communications, and thus reduced protection from unreasonable searches. However, such an assumption may be dangerous and unwarranted when Internet activity is rapidly increasing and more private transactions are conducted via Internet, its result being a downward spiral in the level of protection provided to electronic communications.<sup>109</sup> It is difficult to argue that no expectation exists of online privacy when activities like banking and investing, unquestionably regarded as both personal and confidential, are being conducted through the medium.<sup>110</sup> Technology is swiftly moving our society toward a personal computer-less Internet world, one in which "much of our lives will be in the hands of third parties."<sup>111</sup>

In light of these many technological, societal, and legal developments, the time has come for courts to redefine their standard for determining whether the kind of electronic surveillance made possible by Carnivore violates the Fourth

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104. *See id.* § 1002(b)(2).

105. Frater, *supra* note 42.

106. *Id.* But see *United States Telecom Ass'n v. FCC*, 227 F.3d 450 (D.C. Cir. 2000) (holding that call waiting and call forwarding records are outside of the scope of what is attainable under wiretap orders and suggesting that CALEA would not permit the government to use a lower legal standard engaging in electronic mail surveillance).

107. Joe Borders, *Finding Security Online: You're Not Being Paranoid; Someone Really Is Watching You*, TEX. LAW., July 31, 2000, at 27.

108. *Id.* (noting that there are companies that sell encryption devices so that an Internet user may engage in anonymous browsing).

109. *Devouring Privacy*, *supra* note 36.

110. *Digital Privacy*, *supra* note 19 (statement of Michael O'Neill).

111. *Id.*



Amendment. Currently, in order for a claimant to prevail on privacy grounds in cases alleging unreasonable searches, one must show a subjective expectation of privacy and that this expectation is one society recognizes as reasonable.<sup>112</sup> As applied to Internet communications, it seems likely that most claimants, given the nature of the personal business conducted via the medium, could make strong arguments supporting these subjective expectations of privacy. Therefore, only the question of whether a societal expectation of online privacy is reasonable needs to be considered. Based on the evidence surrounding Internet use, this question could likely be answered in the affirmative.

#### IV. RESOLUTION REQUIRES NATIONAL AND INTERNATIONAL CONSIDERATION

##### *A. The United States*

Resolving the issues surrounding the use of Carnivore and its international cousins calls for a multifaceted intervention. Ultimately, a combination of actions is likely required. Existing laws should be strengthened to ensure greater privacy protections, coupled with proper and regular oversight of government electronic surveillance networks. Likewise, comprehensive, forward-thinking legislation should be passed, rather than piecemeal statutes that result in applicable laws lagging behind electronic surveillance practices. Together, these actions will aid in quieting controversy over this form of electronic surveillance. Therefore, the following recommendations, although some dependent upon others, are offered to be considered as parts of a larger scheme, or in some cases, as alternatives to one another.

1. *Addressing Constitutional Concerns.*—When Carnivore is used specifically to seize the contents of electronic mail messages of suspected criminals in cases in which probable cause warrants have been issued, the search appears not to contravene the Fourth Amendment. However, there are three ways in which the FBI's use of Carnivore may controvert the Fourth Amendment. First, Carnivore's ability to search all electronic mail, even when its operation attempts to limit the search to the communications of suspected criminals, invariably means that the communications of innocent parties from whom mail is received and to whom mail is sent by a suspected criminal is searched in the process. Searches of innocent parties' electronic mail messages, for which no proper judicial authorization exists, might violate the Fourth Amendment.<sup>113</sup>

Along these same lines, the relative ease with which people can forge electronic mail messages (sending messages from another person's account), suggests that even under an ostensibly proper warrant, a Carnivore search could

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112. *Katz v. United States*, 389 U.S. 347, 361 (1967) (Harlan, J., concurring).

113. To find that these searches violate the Fourth Amendment would require the Supreme Court to articulate a clear standard of what constitutes a reasonable search related to electronic mail communications. Currently, the Court likely views these communications as unprotected by the Fourth Amendment due to a misperception that electronic mail users have a decreased expectation of privacy. See *supra* Part III.A.

mistakenly focus on an innocent party, capturing that individual's genuine messages along with the forged ones. An ISP or computer specialist may easily be able to detect this information, but Carnivore may not possess the same capacities. If so, this type of search may also violate the Fourth Amendment.

Second, under existing laws, acquiring pen-register and trap-and-trace electronic mail records has not been held to trigger Fourth Amendment protections. Courts should distinguish Internet searches from the less intrusive corresponding telephone pen-register and trap-and-trace searches, and hence recognize the need that these searches be subject to the limitations imposed by the Fourth Amendment. Requiring the government to meet a "probable cause" standard whenever it seeks to intercept electronic mail, header information, or contents, would provide the level of privacy protection to Internet communications contemplated by the Fourth Amendment and called for by Internet users.

Finally, Carnivore is configured to perform sweeping searches. These searches seem to parallel the kinds of broad searches courts have held to be unconstitutional in other contexts, such as those in which passers-by are indiscriminately stopped and searched in an attempt to uncover criminal activity.<sup>114</sup> These constitutional questions are threshold issues requiring ultimate resolution before Carnivore can legitimately be used at all by the FBI, at least in its current form.

2. *Obtain Access to Carnivore.*—In a country built upon a system in which each branch of government guards against abuses of power by the others, Carnivore is currently operating without a watchdog. Making the Carnivore software available to ISPs would be a substantial first step in implementing a system of checks and balances, while at the same time allowing the FBI to use Carnivore for its intended purpose.<sup>115</sup> If ISPs know how Carnivore works and are able to configure inquiries themselves, they can set the limits ordered by courts. In so doing, the configured search would mirror the methods used when law enforcement officials seek telephone records in that telephone companies provide records based on the parameters set in the court order. Furthermore, ISPs' role in the searches would allow them to assure their customers that the integrity of their systems will remain intact, even when the ISPs are required to turn over information to law enforcement agencies in fulfillment of a court order.

In addition to requiring that ISPs have access to the system, Congress should obtain detailed briefings, perhaps classified if necessary, in order to understand Carnivore's design, fallibility, potential for abuse, and whether encryption software could easily defeat its objective. The regular oversight by Congress, coupled with the transfer of control from the FBI to the ISPs, would provide a

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114. See, e.g., *Terry v. Ohio*, 392 U.S. 1 (1968); see also *City of Indianapolis v. Edmond*, 531 U.S. 32 (2000) (holding that the city's drug interdiction checkpoints violated the Fourth Amendment).

115. *Digital Privacy*, *supra* note 19 (statement of James X. Dempsey, Senior Staff Counsel, Center for Democracy and Technology).



buffer between the ISPs' customers and the FBI.<sup>116</sup>

In order to further ease the concerns of its critics and to make Carnivore understandable to Internet users and others, the system should undergo an independent review.<sup>117</sup> The Justice Department agreed to have such an external review conducted in Fall 2000, but the manner by which it went about the process drew additional criticism.<sup>118</sup> Elite academic computer departments, including the Massachusetts Institute of Technology and Purdue University, withdrew themselves from consideration of Carnivore's review, objecting to the acute limitations imposed on it by the Justice Department.<sup>119</sup> When the Illinois Institute of Technology's Research Institute was finally selected to conduct the review, the Justice Department was again sharply criticized for choosing a team that included a former policy advisor to President Clinton, a former Justice Department official, and other members with backgrounds in the National Security Agency (NSA), the Department of Defense, and the Department of the Treasury.<sup>120</sup> The preliminary report of the research institute, released by the Justice Department in November 2000, unsurprisingly gave Carnivore a relatively clean bill of health, recommending only slight tweaking to the system to prevent unlawful interceptions.<sup>121</sup> However, the report's seemingly biased origins instill little confidence that the concerns over Carnivore's potential for misuse are unjustified.

The FBI articulates what it doubtlessly regards as legitimate reasons to oppose the release of Carnivore's operating code, as it could potentially be used as a source from which hackers could develop ways to defeat the system. However, since the technological knowledge that provided for Carnivore's construction was available to the government, it seems highly likely that knowledge to circumvent the system is available to skilled hackers. Subjecting Carnivore to peer review might illuminate ways of solidifying the code against potential attacks by individuals seeking to undermine the system.

Assuming *arguendo* that the FBI should not reveal Carnivore's source code, it should at least conduct a laboratory test of the system, the complete results of which could be made public. Such an overt testing of each of Carnivore's

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116. *Id.* (statement of Michael O'Neill); *see also* Frater, *supra* note 42 (quoting Rep. John Conyers Jr.'s statement made during a hearing on Carnivore with the FBI: "So should we now be comfortable with a 'trust us we're the government' approach? I don't think anybody on the [congressional oversight] committee has that view.").

117. D. Ian Hopper, *Critics Denounce Carnivore Review*, AP ONLINE, Oct. 4, 2000, at 2000 WL 27902983 (discussing the Justice Department's choice of alleged "government insiders" to conduct an "independent review" of the Carnivore system released in November 2000).

118. *Id.*

119. *Id.*

120. *EPIC Gets First Set of FBI's "Carnivore" Documents*, *supra* note 17.

121. David A. Vise & Dan Eggen, *Study: FBI Tool Needs Honing; Panel Says "Carnivore" Software Can Be Altered to Protect Rights*, WASH. POST, Nov. 22, 2000, at A02. *See generally* Ill. Inst. of Tech. Research Inst., *Independent Review of the Carnivore System Draft Report*, (Nov. 17, 2000), available at [http://www.usdoj.gov/jmd/publications/carniv\\_entry.htm](http://www.usdoj.gov/jmd/publications/carniv_entry.htm).

capabilities, indicating the evidence gathered as a result of the searches, may increase public trust in the government's legitimate use of the system for certain purposes.

3. *Determine Statutory Authorization.*—Based on the FBI's current stretch of existing statutory laws to justify its authority to develop and use Carnivore, Congress should articulate whether such a statutory basis is reasonable. There are at least two ways in which the use of Carnivore seems to exceed the government's allowable use and employment of electronic surveillance laws.

First, the sheer fact that the laws upon which the FBI relies as its mandate to use Carnivore were initially passed to make lawful the interception of electronic communications that by today's standards seem archaic makes the claimed authority questionable.<sup>122</sup> Neither the public nor Congress should simply acquiesce in the use of Carnivore because the FBI says the system is necessary. To do so would perhaps encourage the FBI to conduct electronic surveillance in a manner in which U.S. citizens never intended to tolerate.

Admittedly, among the problems inherent in enacting legislation affecting technology is the patent difficulty posed in keeping up with technological advances. Therefore, Congress must enact laws comprehensive and resilient enough to accommodate such growth or constantly have its fingers on the pulse of developing technology so as to regularly engender laws responsive to current technological trends. Obviously, such constant oversight cannot be accomplished by the entire Congress, but could be performed by legislative committee or an external group held accountable to Congress. The challenging issues presented by advances in the ability of the government to spy on its citizens using increasingly sophisticated technology is a dynamic area of the law that warrants such attention. Perhaps the best solution is found in combining both propositions—enacting comprehensive legislation and providing regular oversight.

A second issue requiring resolution is whether the government has the authority to compel ISPs to participate in the interception of the electronic mail of its customers and those with whom they correspond. CALEA makes it clear that ISPs do not have to modify their equipment to accommodate the government's interception of electronic mail.<sup>123</sup> Yet, arguably, the attachment of Carnivore represents a substantial modification, whether or not the ISP itself affixes the system. A recent attachment of Carnivore by the FBI to one ISP's equipment exposed Carnivore's incompatibility with the ISP's operating system, causing the ISP to have to install an old version of its operating system.<sup>124</sup> The

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122. See, e.g., 18 U.S.C. § 3127(3) (1994) (defining a pen-register device as one that records or decodes electronic impulses and identifies numbers transmitted on a telephone line to which the device is attached). Under this definition, Carnivore clearly fails to qualify as a pen-register device. Yet, the FBI cites ECPA as granting it the authority to acquire e-mail addresses.

123. *Id.* § 1002(b)(2).

124. Nick Wingfield et al., *Companies: FBI's New Surveillance Device Refused by U.S. Web Provider*, WALL ST. J. EUR., July 14, 2000, available at 2000 WL-WSJE 21066306.



system crashed and disrupted service to a number of its customers.<sup>125</sup> Whether the ISP was “compelled” to modify its equipment to accommodate the FBI’s interception of targeted electronic mail is certainly open to question, but assuming that it did not welcome the opportunity to downgrade its operating system illustrates that the FBI may not be adhering to CALEA’s unambiguous provisions, or at the very least its spirit. Therefore, it is imperative that Congress determine if any statutory authority exists to permit the FBI to require ISPs to either install the system or have the system installed on their equipment.<sup>126</sup>

4. *Modify Existing Laws and Enact Comprehensive Legislation.*—If Congress does not pass comprehensive legislation, the risk of individual states enacting their own laws to bolster privacy protections of the Internet using citizenry looms largely. Such a reaction from states could worsen the current nationwide situation, leading to multifarious laws and policies governing Internet use and surveillance being enacted because the federal laws do not provide adequate protection. With the landscape of federal electronic surveillance laws as difficult to traverse as it is, states independently enacting legislation would lead to increased uncertainty and imbalanced protections that should be uniformly provided.

Electronic surveillance laws, specifically Title III and the ECPA, are inadequate in their current form when applied to the FBI’s use of Carnivore. The modification of these laws, coupled with new laws, should define exactly the circumstances under which Carnivore can be used and the extent of that use. Most obviously lacking from current law is any unequivocal requirement that law enforcement officials try or at least consider the least intrusive means of investigation before engaging in interception.<sup>127</sup> This procedural safeguard would provide those concerned about their privacy with some assurance that a judge has heard compelling evidence substantiating law enforcement officials’ need to make use of Carnivore to monitor a suspected criminal’s electronic mail. In other words, using Carnivore should be law enforcement’s act of last resort. Enacting such a law would serve to codify what the FBI purports in its policies already to be doing before using Carnivore.<sup>128</sup>

Taking into account the extraordinary burden imposed on privacy by electronic mail searches, laws should require a heightened uniform standard for court orders that requires ISPs to assemble and produce any Internet communications information. Orders should be granted only after a judge finds that reasonable cause exists to believe that a target has committed or is about to commit a crime. Making orders more difficult to obtain would add an additional safeguard ensuring that law enforcement officials would only use Carnivore in the most extremely necessary situations. As the laws currently exist, it is likely that if the FBI suspects a person of a crime for which electronic mail is being used, it will first attempt to get a court order to access the full contents of the

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125. *Id.*

126. *Digital Privacy*, *supra* note 19 (statement of Michael O’Neill).

127. *Learning to Live with Big Brother*, *supra* note 9.

128. Fed. Bureau of Investigation, *supra* note 45.

mail. Only after such an attempt fails will the FBI settle for a court order that will provide less information.

In compelling a higher standard for court orders, laws should take into account the unique nature of information yielded by even the most rudimentary searches of electronic mail. Carnivore can be used as a content wiretap, trap-and-trace device, or pen register.<sup>129</sup> Internet queries, even those that ascertain only addressing information, subject lines, and web sites visited, provide far more information than what is accessed from pen-register or trap-and-trace telephone records.<sup>130</sup> A subject line has the potential of revealing the entire heart of the message's content.<sup>131</sup> Yet, authorization for obtaining such information from telephone or Internet users is acquired in the same way—from lower-level judges without a probable cause warrant.

In addition to reinforcing the required showing the government must make for court orders to be granted, and as part of an overall approach to Internet mail and other online activities produced as courtroom evidence, laws should require notice and an opportunity for defendants to object when civil subpoenas seek personal information regarding Internet activities.<sup>132</sup> Providing this kind of protection to individuals' right to privacy may have positive implications for future lawmaking and provide a firm foundation for the development of an increased societal expectation of privacy in Internet communications.

Finally, laws governing the use of Carnivore should bring an end to the ambiguity surrounding what information the government can and does gather. Public distrust of the FBI's unfettered use of Carnivore would dissipate if people knew exactly what the law enforcement agencies are permitted to obtain. Requiring the executive branch to provide Internet consumers with notice when the government obtains information regarding their Internet transactions would lead to increased public trust.<sup>133</sup> In addition, requiring specific statistic reports for pen-register and trap-and-trace orders for Internet communications, similar to those reports required under existing legislation for telephone pen-register and trap-and-trace records, would also bolster support for the use of surveillance systems.<sup>134</sup>

Enacting comprehensive laws will serve to disentangle the confusing mixed bag that federal electronic surveillance legislation has become. In doing so, it is imperative to note that Internet users do not have a minimum expectation of

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129. A content wiretap captures all electronic mail and network traffic to and from a specific account. A trap-and-trace device captures the electronic mail addresses from which a user receives mail; a pen register captures the electronic mail addresses to which a person sends messages and those servers and web pages the person accesses.

130. *Learning to Live with Big Brother*, *supra* note 9.

131. For example, a subject line reading "The Case Against Carnivore" would lead viewers well informed in electronic surveillance equipment being used by the FBI to conclude that the message contains arguments against the use of the diagnostic tool.

132. *Digital Privacy*, *supra* note 19 (statement of Michael O'Neill).

133. *Id.*

134. *Id.*



privacy in their use of electronic mail and the World Wide Web as primary sources of personal and professional communications and information.

### *B. The International Community*

As the lines between governments' intelligence agencies and law enforcement agencies converge, increased attention must be given to electronic surveillance practices abroad. No matter what choices the United States makes about its domestic use of Carnivore, the reality of electronic communications surveillance as a global issue demands ethical and responsive leadership on an international level. The United States should promote worldwide adoption of privacy protections as it encourages countries to develop surveillance policies congruent with its own. This policy promotion must be carried out in a systematic manner, at all times taking into account developments in technology.

In practice, achieving congruence in international electronic surveillance policies presents countless challenges. No single country or group of countries can implement electronic surveillance laws without unavoidably interfering with the electronic mail use of other countries' nationals. For example, the European Union is considering approving an international cybercrime treaty that purports to define how countries should handle cybercrimes committed outside their borders.<sup>135</sup> The treaty, which was finalized by committee in June 2001, makes it a crime to access one's computer without the owner's authorization, but parties to the treaty can interpret what constitutes such "authorization" differently.<sup>136</sup>

The potential negative effects of the European Union treaty are easily recognizable. The European Union represents only a handful of the countries of the world. If this small group of countries establishes multiple interpretations of the parameters of "authorization," the consequence in the global community would be the proliferation of increased incompatibility in the way countries treat these concepts. Time is of the essence. If each country of the world implements its own laws, independent from one another, and those laws are challenged in each country's courts as they undoubtedly would be, the result would be a series of mutated statutes governing a global medium, making it all the more difficult to eventually implement what can be nothing other than an international regulatory scheme.

Although there is already at least one international agency charged with setting policy for the Internet,<sup>137</sup> the nature of privacy expectations and the needs

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135. Lisa Porteus, *Achieving Privacy Balance Is More Difficult, Panel Says*, NAT'L L.J.'S TECH. DAILY, Jan. 11, 2001.

136. *Id.*; *Cyber Security: Committee Approves Cyber-Crime Treaty*, NAT'L L.J.'S TECH. DAILY, June 25, 2001; *Digital Privacy*, *supra* note 19 (referring to a statement by Stewart Baker, former general counsel at the U.S. National Security Agency). John Ryan, vice president and associate general counsel for America Online, contends the treaty will open the door to other content-related issues, raising a fundamental issue for resolution—whether an ISP in one country must comply with the content laws in another. *See id.*

137. Semeraro, *supra* note 59.

of law enforcement to have ways in which to engage in surveillance of electronic communications necessitate greater attention devoted to these manifestly international issues. The worldwide controversies that flowed from the ILETS' plans to make countries' telecommunications equipment interception-friendly can now be parlayed into the promulgation of an organization with a much nobler mission—promoting balanced policies and procedures.

This new organization, which could be formed by international treaty or otherwise, should serve not only as a policy-making body, but also as a conduit for the accumulation of worldwide input on electronic privacy concerns. Following appropriate administrative procedures, this agency could provide opportunities for privacy advocates, law enforcement officials, and other interested parties to engage in rigorous debate on how to balance privacy protections with the need to provide for public safety via surveillance. Negotiation among representatives of the compound interests involved, albeit time consuming, could produce desirable regulations acceptable to all stakeholders.

Part of this international organization's undertaking could be to stipulate that nations' law enforcement agencies engaging in Internet-activity surveillance routinely provide statistics for legislative oversight.<sup>138</sup> Review of the use of electronic mail search devices and countries' practices could be a priority for the agency. Among the important outcomes of these records would be the notice it would provide suspected criminals of the attention being paid by the world community to electronic surveillance and the consolation it would provide citizens of the world that their privacy is of paramount importance.

Every citizen of the world engaging in electronic mail communications has a significant stake in seeing to it that all states' governments recognize privacy protection as a remedial aim of electronic surveillance. Whether sending a message to a friend across town, to a family member in another part of the country, or to a business counterpart overseas, Internet users need to be confident that their messages will not be intercepted by their or anyone else's government. Given the technical capabilities of Carnivore in the United States and Carnivore-like systems in other countries, as well as the broad interpretations of laws by those using them, citizens worldwide using the Internet as their primary means of communication currently lack such assurance.

#### CONCLUSION

At the close of the year 2000, the Denver-based, non-profit Privacy Foundation put the FBI's use of Carnivore on its short list of the most important privacy issues of the year.<sup>139</sup> Given the potential of Carnivore to affect adversely

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138. *Digital Privacy*, *supra* note 19 (statement of Michael O'Neill) (referring to U.S. Congress, but seemingly applicable to other countries' governments as well).

139. Robert Trigaux, *Technology Endangers Privacy Like Never Before*, ST. PETERSBURG TIMES, Jan. 3, 2001, at 1E. The other privacy issues on the list were: workplace surveillance, patient privacy rules, DoubleClick's profiling of Internet surfers, the rise of chief privacy officers,



every sender and receiver of electronic mail, Carnivore's placement on the list is not unexpected. Arguably, the greatest of Carnivore's grave flaws is the impact its use will have on individuals' personal, not to mention professional, lives.

As an illustration, consider its impact on one aspect of the practice of law. Legal technology experts predict that one outcome of the Carnivore furor will be an increased interest among lawyers and their clients in electronic mail security.<sup>140</sup> An electronic mail message sent from an attorney to a client or sent from a client to his or her attorney could be a target of Carnivore's probe. Without either the sender or receiver being aware of it, the message could be intercepted by the FBI and used against the client in court, destroying the client-attorney privilege that might otherwise have protected the communication from its use against the client.

The FBI chose to implement its use of Carnivore without considering what U.S. citizens would accept when it comes to giving up a measure of their precious privacy rights. Carnivore's capabilities, coupled with the FBI's unwatched use of the diagnostic tool, are an affront to those privacy rights. In short, the government is telling U.S. citizens to leave their front doors open so that officials may walk through their homes when looking for the suspects they are pursuing. As it stands, the order is unendurable.

If Carnivore, or its successors, is to be tolerated by U.S. citizens and pass constitutional muster, extensive national and international work must be accomplished to alleviate privacy concerns. In the United States, the question of whether Carnivore is constitutionally permissible must be answered. In its current configuration, the answer is most likely no. Obtaining access to the precise nature of Carnivore's aims, exactly how it is used and its potential for abuse, will help provide the answers to further uncertainties about the investigative tool. Adopting comprehensive legislation, including the modification of existing laws to strengthen Internet users' privacy protections, could lead to a legislative scheme acceptable to both law enforcement agencies and those concerned about privacy. Internationally, the United States has to take the lead in convening countries' representatives to fashion solutions to what is a major global concern. Among those strategies employed by the group must be the adoption of worldwide policies that allow governments access to the electronic communications they need to engage in crime prevention while protecting worldwide Internet users' expectation of privacy. Contribution to these policies must be sought from a wide range of interested parties.

Conceptually, the ability of law enforcement agencies to be able to access the communications of criminals is benign. Most people would probably be willing to give up a certain degree of privacy in furtherance of the state's interest and

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inconsistent privacy policies, merging personal financial data, wireless privacy battles, Microsoft cookie-blocking software, and electronic mail and World Wide Web activity sought in legal cases. *Id.*

140. Dennis Kennedy, *Changes to Come: Legal Technology Predictions for 2001*, IND. LAW., Jan. 3, 2001, at 9 (writing about statement of Jerry Lawson, lawyer and Internet expert).

responsibility in curtailing the growing number of crimes being conducted using the Internet as a means of communication. Most objectionable, however, about the government's approach to advanced electronic surveillance is the secrecy with which it has pursued its objectives. Without releasing the details of the Carnivore operating system and the precise agenda of the ILETS, the U.S. government could have nonetheless subjected itself to following basic procedures of formal rulemaking in administrative law—an opportunity for notice and comment. Notice would serve a dual purpose. First, it would provide forewarning to criminals that should they choose to engage in criminal conduct using the Internet, law enforcement agencies may have access to those communications. Second, it would provide those interested stakeholders with an assurance that the government values their input, whether that input were eventually to influence law enforcement agencies' policies. A period for comment would provide a means by which those interested parties could participate in the development of policy that affects one of their perceived indispensable rights. This democratic exercise could serve as a model to the broader international community working collectively with the United States toward achieving vital compatible goals—crime prevention and the preservation of individuals' right to privacy.



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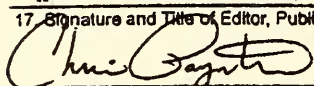
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